No. 01-1418-CFX Title: A. Elliott Archer, et ux., Petitioners
v.
Arlene L. Warner

Docketed: March 26, 2002 Court: United States Court of Appeals for the Fourth Circuit

Entry	Date	Proceedings and Orders
	Mar 22 2002	Petition for writ of certiorari filed. (Response due May 24, 2002)
	Apr 17 2002	Order extending time to file response to petition until May 24, 2002.
	May 24 2002	Brief of respondent Arlene L. Warner in opposition filed.
	May 30 2002	Reply brief of petitioners A. Elliott Archer and Carol Archer filed.
	Jun 4 2002	DISTRIBUTED for Conference of June 20, 2002
	Jun 24 2002	Petition GRANTED. SET FOR ARGUMENT January 13, 2003. **********
	Aug 5 2002	Consent to the filing of any and all amicus briefs in support of either party received from counsel for the petitioners.
	Aug 6 2002	Consent to the filing of amicus briefs in support of the petitioners received from counsel for the respondent.
	Aug 7 2002	Brief amici curiae of Ohio, et al. filed.
	Aug 8 2002	Brief amicus curiae of United States filed.
	Aug 8 2002	Joint appendix filed.
	Aug 8 2002	Brief of petitioners A. Elliott Archer and Carol A. Archer filed.
	Aug 8 2002	Brief amicus curiae of G. Eric Brunstad, Jr. filed.
	Aug 8 2002	Brief amicus curiae of AARP filed.
	Aug 26 2002	Order extending time to file respondent's brief on the merits to and including October 7, 2002.
	Sep 18 2002	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
	Oct 7 2002	Brief of respondent Arlene L. Warner filed.
	Nov 4 2002	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
	Nov 6 2002	Reply brief of petitioners A. Elliott Archer and Carol A. Archer filed.
	Nov 21 2002	CIRCULATED.
	Dec 6 2002	Record filed.
	Jan 6 2003	Letter from counsel for the petitioner received and distributed.
	Jan 7 2003	Record filed.
	Jan 13 2003	ARGUED.

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No. 01-

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 523(a)(2) of the Bankruptcy Code provides that a debt for money obtained by means of fraud (and certain other categories of debt) is not dischargeable in bankruptcy. This case presents a question that has divided the courts of appeals: whether an otherwise nondischargeable debt becomes dischargeable if the parties enter into a settlement agreement resolving the amount of the debt.

PARTIES TO THE PROCEEDING

The only parties to this proceeding are identified in the caption.

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IN THE

Supreme Court of the United States

No. 01-

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITION FOR A WRIT OF CERTIORARI

Petitioners A. Elliott Archer and Carol Archer respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS AND JUDGMENT BELOW

The opinion of the Court of Appeals, --- F.3d ---, 2002 WL 369926 (4th Cir. 2002), (Pet. App. 1a-16a) is not yet reported. The opinions of the district court (Pet. App. 17a-25a), and of the bankruptcy court (Pet. App. 29a-36a) are not reported.

JURISDICTION

The opinion of the Court of Appeals was issued on March 8, 2002. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Section 523(a)(2)(A) of Title 11, United States Code (the "Bankruptcy Code") provides: "A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud . . . ." 11 U.S.C. § 523(a)(2)(A). Section 523(a)( ) of the Bankruptcy Code further excepts from the discharge debt "for willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. § 523(a)(6). The complete text of Section 523(a) of the Bankruptcy Code is set forth at Pet. App. 43a-48a.

STATEMENT OF THE CASE

Section 523(a) of the Bankruptcy Code provides that certain categories of debt, including debt for money obtained by means of fraud, are not dischargeable in bankruptcy. This case presents a question that has divided the courts of appeals: whether an otherwise nondischargeable debt becomes dischargeable if the parties enter into a settlement agreement resolving the amount due, in which a release of the underlying claim is given in exchange for a promise to pay the agreed debt.

In this case, a divided panel of the Fourth Circuit ruled that a settlement agreement effects a "novation," so that the debt due under the settlement agreement is no longer considered a debt for money obtained by means of fraud. Rather, the court concluded, the debt is an ordinary contract debt, fully dischargeable in bankruptcy. (*See* Pet. App. 7a-10a.) In so ruling, the Fourth Circuit followed the reasoning of the Seventh and Ninth Circuits. *See In re Fischer*, 116 F.3d 388 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994); *Gonder v. Kelley*, 372 F.2d 94 (9th Cir. 1967) (per curiam); *Maryland Cas. Co. v. Cushing*, 171 F.2d 257 (7th Cir. 1948).

As the Fourth Circuit acknowledged, however, the D.C. Circuit and the Eleventh Circuit have reached the opposite conclusion, holding that the congressional policy of excepting certain debts from the discharge requires bankruptcy courts to inquire into the underlying source of the debt at issue to determine whether it is dischargeable. *See United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983). This Court should review the decision below to resolve this important and recurring issue of federal bankruptcy law that has divided the courts of appeals.

1. A corporation formed by Petitioners A. Elliott and Carol Archer bought the assets of Warner Manufacturing, Inc., for $685,000 from its principals, Leonard L. Warner and Respondent Arlene Warner. The sale closed on May 22, 1992. Despite representations made by the Warners that the underlying business was a very profitable one, upon taking possession of the assets the Archers discovered that the financial statements provided to them by the Warners, along with other representations made by the Warners in connection with the sale, were materially false, and that the business was in fact losing substantial sums of money. The Archers accordingly brought suit against the Warners and Warner Manufacturing in state court in North Carolina asserting various claims, including common law fraud.

After much discovery, the parties (on the eve of trial) entered into a settlement agreement under which the Archers would receive $300,000, consisting of a $200,000 cash payment and a secured promissory note for $100,000 payable in two installments over a year. In the settlement agreement,

the Archers granted the Warners a standard release of any and all claims the Archers may have had against the Warners. The Warners defaulted on the first payment under the promissory note, due on November 11, 1995. The Archers brought suit in state court in North Carolina to recover on account of the debt due to them, arising from the underlying fraud allegations, reflected in the promissory note.

2. While the state court action was pending, Leonard and Arlene Warner filed for relief under chapter 13 of the Bankruptcy Code. Their case was subsequently converted to chapter 7. The Archers brought an adversary proceeding in the bankruptcy case against the Warners, seeking a declaratory judgment that the debt was nondischargeable on the ground, *inter alia*, that it was for money owed on account of fraud. 11 U.S.C. § 523(a)(2).[1] Leonard Warner did not contest the issue of dischargeability in bankruptcy court, which entered a consent judgment against him. (Pet. App. 39a-41a.) Arlene Warner did contest dischargeability, and the bankruptcy court held a trial on the question whether the debt she owed to the Archers would be discharged.

After trial, the bankruptcy court concluded, following decisions of the Seventh and Ninth Circuits, that the settlement agreement effected a "novation," such that the debt due by Arlene Warner to the Archers was no longer a debt due on account of fraud, but instead simply a debt due on a contract. (Pet. App. 33a-35a.)[2] The district court

---

1 The Archers subsequently sought to amend their complaint to allege that the settlement agreement was procured by means of fraud. The bankruptcy court denied the motion for leave to amend the complaint. In the district court and the court of appeals, the Archers contended that the bankruptcy court abused its discretion in denying such leave. The Archers do not press that issue before this Court.

2 Because a consent judgment had been entered against Leonard Warner, the bankruptcy court's final disposition of the claims against Arlene Warner represented a final judgment, (Pet. App. 39a), appealable to the district court under 28 U.S.C. § 158(a)(1).

affirmed, agreeing with the bankruptcy court that because the underlying fraud claim had been settled and a general release given, further inquiry into the nature of the underlying debt was prohibitted. The remaining debt was, as a matter of law, simply a claim on the note, and not a debt for money obtained by means of fraud. (Pet. App. 20a-25a.)

3. A divided panel of the Court of Appeals affirmed. The panel majority expressly acknowledged that "there is a split among the circuits concerning this issue," but – like the bankruptcy and district courts – it adopted the "novation theory" embraced by the Seventh and Ninth Circuits. The court explained that its approach would encourage settlement: "Under this theory, parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise the incentive to settle is gone." (Pet. App. 8a.)

Judge Traxler dissented, urging that the approach taken by the D.C. and Eleventh Circuits better serves the underlying congressional judgment that certain debts should not be discharged in bankruptcy. He wrote that "a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress . . . merely by altering the *form* of his debt through a settlement agreement." (Pet. App. 12a (quoting *Spicer*, 57 F.3d at 1156) (omission and emphasis in original).) "[I]f, as the Supreme Court has declared, 'the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt' . . . then I see no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry." (Pet. App. 15a (quoting *Brown v. Felsen*, 442 U.S. 127, 138 (1979)).)

REASONS FOR GRANTING THE WRIT

The Court should grant the petition to resolve a square, acknowledged, and mature split among the circuits on an important and recurring question of federal law. Section 523(a) of the Bankruptcy Code reflects the balance Congress has struck between the interest in providing debtors with a "fresh start," and the rights of certain classes of creditors to continue to collect their debts notwithstanding the debtor's bankruptcy. The question presented in this case is whether a debt that would otherwise be nondischargeable becomes dischargeable if the parties enter into a settlement agreement resolving the amount due on account of the fraud. The court of appeals below, joining the Seventh and Ninth Circuits, held that a settlement on an otherwise nondischargeable debt is a "novation" that renders the debt dischargeable – like an ordinary commercial debt. The D.C. and Eleventh Circuits have reached the opposite conclusion, holding that a settlement should be treated no differently from a judgment.

The decision below, prohibitting courts from inquiring into the underlying nature of a settled debt, is incorrect. Just as this Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979), requires a bankruptcy court to look behind a judgment to determine if the underlying debt arose on account of fraud, so too should a bankruptcy court look behind a settlement agreement to determine whether the underlying debt is properly dischargeable under the Bankruptcy Code. As Judge Traxler explained in dissent below, referring to this Court's decisions in *Brown*; *Cohen v. de la Cruz*, 523 U.S. 213 (1998); and *Grogan v. Garner*, 498 U.S. 279 (1991): "the message delivered by a unanimous Supreme Court on three separate occasions has been clear. In deciding cases dealing with the fraud exceptions to dischargeability, courts should effectuate congressional policy objectives by conducting the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor." (Pet. App. 15a.)

I. THE COURT SHOULD RESOLVE THE CONFLICT AMONG THE CIRCUITS ON THE QUESTION WHETHER A SETTLEMENT AGREEMENT EFFECTS A "NOVATION" THAT CONVERTS AN OTHERWISE NONDISCHARGEABLE DEBT INTO A DISCHARGEABLE ONE.

Both the majority and dissenting opinions of the Court of Appeals observed that the decision below creates a 3-2 circuit split on the question presented. As Judge Traxler observed in dissent, there are "two competing views" on the question presented (Pet. App. 11a), each of which has been fully developed in thoughtful opinions of the courts of appeals – not to mention the numerous opinions of the bankruptcy and district courts on this issue.[3]

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[3] Following the D.C. and Eleventh Circuit approach: *In re Francis*, 226 B.R. 385, 391 (6th Cir. B.A.P. 1998); *In re Detrano*, 266 B.R. 282 (E.D.N.Y. 2001), *reversing* 222 B.R. 685 (Bankr. E.D.N.Y. 1998), *In re Richardson*, 221 B.R. 956 (D. Wyo. 1998); *In re Turner*, 179 B.R. 273 (Bankr. D. Colo. 1995); *In re Williams*, No. 93 CV 74258, 1994 WL 930884 (E.D. Mich. May 31, 1994); *In re Guerrerio*, 143 B.R. 605, 611 (Bankr. S.D.N.Y. 1992); *In re Marceca*, 129 B.R. 371 (Bankr. S.D.N.Y. 1991); *In re Carnahan*, 115 B.R. 697 (Bankr. D. Colo. 1990); *In re Bobofchak*, 101 B.R. 465 (Bankr. E.D. Va. 1989); *In re Peters*, 90 B.R. 588 (Bankr. N.D.N.Y. 1988); *In re Pavelka*, 79 B.R. 228 (Bankr. E.D. Pa. 1987); *In re Kovacs*, 42 B.R. 1 (Bankr. D. Mass. 1982); *In re Rush*, 33 B.R. 97 (Bankr. D. Me. 1983).

Following the Fourth, Seventh, and Ninth Circuit approach: *In re Kelley*, 259 F. Supp. 297 (N.D. Cal. 1965), *aff'd*, 372 F.2d 94 (9th Cir. 1967); *In re Fultz*, 232 B.R. 709 (Bankr. N.D. Ill. 1999); *In re Morris*, 230 B.R. 352 (Bankr. N.D. Ill. 1999); *In re Detrano*, 222 B.R. 685 (Bankr. E.D.N.Y. 1998), *rev'd*, 266 B.R. 282 (E.D.N.Y. 2001); *In re Rieder*, 178 B.R. 373 (Bankr. S.D.N.Y. 1995) (dicta), *aff'd*, 194 B.R. 734 (S.D.N.Y. 1996), *aff'd*, 116 F.3d 465 (2d Cir. 1997); *In re Anderson*, 64 B.R. 331 (Bankr. N.D. Ill. 1986).

See also In re Shervin, 112 B.R. 724, 735 n.8 (Bankr. E.D. Pa. 1990) (noting dispute and collecting cases).

Individual debtors in chapter 7 bankruptcy cases typically will receive, at the end of their bankruptcy proceedings, a discharge of debts owed as of the filing of their bankruptcy petitions. 11 U.S.C. § 727. The Bankruptcy Code, however, "has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying the basic policy of the Code to afford relief only to an 'honest but unfortunate debtor.'" *Cohen*, 523 U.S. at 217 (quoting *Grogan*, 498 U.S. at 287). Most other debts, such as debts for money borrowed to purchase goods or obtain services, are discharged in bankruptcy.

The question presented here is whether, under Section 523(a), a settlement agreement resolving an otherwise nondischargeable claim (such as a claim for money obtained by means of fraud), containing a standard general release, should be read to effect a "novation," converting the underlying (nondischargeable) debt, such as one for fraud, into a "new" (and dischargeable) ordinary commercial debt. Even before the decision below, the Seventh and Ninth Circuits had answered this question in the affirmative. Those courts had held that when a settlement is reached with respect to an otherwise nondischargeable debt, in which the plaintiff grants the defendant a general release in exchange for a promise to pay the agreed debt, such agreement creates a new debt that is no longer traceable to its underlying source, such as fraud. Rather, the settlement agreement represents a new and separate contract. As the Ninth Circuit explained the point, when a promissory note "by express agreement is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action and it would be error for the court to look behind the note." *Fischer*, 116 F.3d at 390 (citation omitted). The panel majority below adopted this line of reasoning:

> We agree with the district court and the bankruptcy court that the better reasoned decisions are those of the Seventh and Ninth Circuits, rather than those of the District of Columbia and Eleventh Circuits. So we follow *West*, *Md. Casualty*, and *Fischer*. We are of the opinion that Congress did not intend that 11 U.S.C. § 523(a) be construed, as a reversal here would require, so as to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a).

(Pet. App. 8a.)

The D.C. and Eleventh Circuits have reached the opposite conclusion, holding that as a matter of federal bankruptcy law, a court is required to look behind the note to determine whether the underlying debt that was settled is a nondischargeable debt under Section 523(a) of the Bankruptcy Code. Those courts have held that a debt that "originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement." *Greenberg*, 711 F.2d at 156; *Spicer*, 57 F.3d at 1155. As the D.C. Circuit explained in *Spicer*, "[a] debtor's 'fresh start' is not absolute." 57 F.3d at 1156 (citation omitted). "Congress has unmistakably mandated in Section 523(a)(2)(A) that [debtors] may not get a fresh start at the expense of defrauded third parties." *Id.* (citations omitted).

Indeed, even before the Fourth Circuit issued the opinion below, the D.C. Circuit had already observed in *Spicer* that the Seventh Circuit's opinions in *West* and *Maryland Casualty* adopting the "novation" theory "cannot be reconciled," *id.*, with the Eleventh Circuit's *Greenberg* decision, which the D.C. Circuit itself followed.

> Following *Greenberg v. Schools*, we look beyond the form of the settlement agreement to the substance of the underlying obligation, and conclude that Spicer's debt to the government did indeed 'originate from' and 'derive from' his fraudulent conduct. Although the subsequent settlement agreement alters the legal form of that

> obligation, it does not transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy.

Id. at 1157; *see also* David Zelikoff, *Fraud By Any Other Name Is Still Fraud: Settling A Potential Fraud Claim Under The Bankruptcy Code*, 64 Geo. Wash. L. Rev. 866, 874 (1996) ("The fraudulent debtor cannot escape liability by using the Bankruptcy Code to his advantage, because it is the substance that underlies the creditor's claim, not the current form of the debtor's debt that will determine applicability of the fraud exception.").

The merits of the competing positions have been amply developed in the various court of appeals decisions, as well as in the many decisions of the bankruptcy and district courts on this point. This Court should grant certiorari to resolve the circuit split.

II. THE QUESTION PRESENTED IS AN IMPORTANT ONE THAT WARRANTS THIS COURT'S REVIEW.

The decision below is incorrect. If allowed to stand, it would have potentially wide ranging consequences throughout bankruptcy law, and threatens to open a gaping hole in this Court's repeated admonition that the discharge is available only to the "honest but unfortunate" debtor, and that bankruptcy courts must make full inquiry into an underlying debt to determine whether it is dischargeable.

First, the decision cannot be reconciled with this Court's holding in *Brown*, 442 U.S. at 127, that when a matter is litigated to a judgment, the bankruptcy court should look behind the pleadings to determine whether the underlying debt is properly dischargeable under the Bankruptcy Code. The specific holding of *Brown* is that the doctrine of *res judicata* does not prevent the bankruptcy court from looking

beyond the face of the underlying judgment itself. Rather, it would be the role of the bankruptcy court to examine the underlying nature of the claim and "make an accurate determination whether [the debtor] in fact committed . . . fraud." *Id.* at 138. "They are the type of question Congress intended that the bankruptcy court would resolve." *Id.*

The decisions of the Fourth, Seventh, and Eleventh Circuits clash sharply with this principle announced in *Brown* that Congress intended bankruptcy courts to "make an accurate determination whether [the debtor] in fact committed . . . fraud . . . . " *Id.* While these courts have suggested that a settlement agreement effects a "novation," such that the debt being enforced is no longer based on the underlying claim of fraud, but rather the "new" claim on a contract, it is difficult to see why an action to enforce a settlement agreement should be any "newer" than an action to enforce a judgment. By the same token, bankruptcy law should presumably treat a general release, in a matter that is settled, just as it treats the *res judicata* effect of a judgment entered by a court. The *Brown* decision holds that notwithstanding the doctrine of *res judicata*, a plaintiff who has won a judgment may argue in bankruptcy court that the underlying debt was for money owed on account of fraud, even if that fact is not revealed in the underlying pleadings. *Id.* at 134-39. The same should be true where the underlying lawsuit is settled and a release is given. In both cases, the principles that undergird Section 523(a) suggest that a bankruptcy court should make its own inquiry into whether the underlying debt is or is not dischargeable under the Bankruptcy Code. In any event, there is no basis for treating a settlement differently from a judgment in this regard.

Second, contrary to the statement of the court of appeals below, the rule that now controls in the Fourth, Seventh, and Ninth Circuits stands as an obstacle to settlement of any fraud claim whenever the plaintiff perceives any risk that the defendant may subsequently seek bankruptcy protection. Any well-advised plaintiff to a fraud action would appreciate

that if the matter were litigated to a judgment, that judgment would be exempt from discharge in bankruptcy if the underlying debt was for money owed on account of fraud.

The court of appeals suggested that the rule it adopted was necessary to encourage settlement. "[P]arties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise, the incentive to settle is gone." (Pet. App. 8a.) To be sure, the court of appeals' rule does make settlement more attractive to the *defendant* in a fraud action, who is now able to convert an otherwise nondischargeable debt into a dischargeable one. But by the same token, it makes settlement that much *less* attractive to the *plaintiff*, who by settling gives up the right to have a claim that would otherwise survive the debtor's bankruptcy. Indeed, because the plaintiff will never have the same quality and quantity of information regarding the defendant's financial position and intention to file for bankruptcy as will the defendant, the net effect of this rule is likely to chill settlement even in cases in which the defendant did not, in fact, intend to seek bankruptcy protection. Moreover, insofar as the rule does encourage settlements, it will encourage settlements in which a debtor, before filing for bankruptcy, secures a release of a fraud claim from an unsuspecting creditor, in exchange for what is, in effect, an empty promise to pay the debt.

Third, the decisions of the Fourth, Seventh, and Ninth Circuits threaten to open a gaping hole in a fundamental principle of bankruptcy law, often repeated in decisions of this Court, that the discharge in bankruptcy is intended to be limited to honest but unfortunate debtors. In *Grogan*, for example, this Court held that nondischargeability need be proven by the creditor by the preponderance of the evidence standard. The Court observed that "it is unlikely that Congress, in fashioning the standard of proof that governs the applicability of these provisions, would have favored an interest in giving the perpetrators of fraud a fresh start over

an interest in protecting the victims of fraud." 498 U.S. at 287. In *Field v. Mans*, 516 U.S. 59 (1995), a case establishing the "justifiable reliance" standard for determining whether a debt is for money obtained by means of fraud, the Court similarly noted that the exceptions to the discharge to debts obtained by fraud are not congressional "innovations," but date back to Section 17(a) of the Bankruptcy Act of 1898. *Id.* at 65-66. Finally, in *Cohen*, which holds that treble damages owed on account of fraud are nondischargeable, the Court further emphasized "the historical pedigree of the fraud exception, and the general policy underlying the exceptions to the discharge." 523 U.S. at 223. Moreover, insofar as the rule established by the Fourth, Seventh, and Ninth Circuits, as it is intended, encourages defendants approaching bankruptcy to enter into settlement agreements – the effect of which would be to render dischargeable otherwise nondischargeable debt – it would actively undermine these policy objectives that Congress sought to achieve in establishing exceptions to the discharge, and that this Court has regularly noted.

Fourth, there is no principled basis to limit the court of appeals' rule to debt obtained by fraud. Section 523(a) of the Bankruptcy Code lists 18 separate exceptions to the discharge, each reflecting a congressional judgment that creditors owed those types of debt should retain their ability to seek repayment as against a debtor notwithstanding the discharge. These include debts due to a former spouse or child for alimony, maintenance, or support, 11 U.S.C. § 523(a)(5); for death or personal injury caused by drunken driving, 11 U.S.C. § 523(a)(9); for certain state or federal income taxes due, 11 U.S.C. § 523(a)(1); and for money due under educational loans, 11 U.S.C. § 523(a)(8). Because each of these types of debt may be subject to bona fide dispute, parties will commonly enter into settlement agreements resolving such disputes, liquidating the debts, and granting general releases.

Indeed, the debt at issue in this case arises not only out of Respondent's alleged fraud, but also seeks "emotional distress/personal-injury-type damages" asserted "in a case involving prosecution of a legal suit or action based upon tort or tort-type rights," (Pet. App. 9a-10a), and may be excepted from the discharge under Section 523(a)(6) (excepting from the discharge debt for "willful and malicious injury by the debtor to another entity or to the property of another entity"). The Seventh Circuit's decision in *West*, moreover, involved a settlement regarding debt for money that was embezzled, and thus – but for the settlement agreement in which the embezzler agreed to repay the amounts stolen – nondischargeable under Section 523(a)(4). *In re West*, 22 F.3d 775, 777 (7th Cir. 1994).

The reasoning of the Fourth, Seventh, and Ninth Circuits, however, requires that such a settlement agreement – whether it arises out of a debt for alimony and support, money obtained by fraud, embezzlement, or income taxes due – be deemed a "novation" that converts the underlying debt, whatever its original source, into an ordinary contract debt. "[S]uch contractual claims are then dischargeable in bankruptcy." (Pet. App. 8a.) "This conclusion can result only from blind adherence to strict legal principles. Thus, while it is true that a 'new' legal obligation has arisen, the fact is inescapable that its origin lay in the old one; and to ignore the obvious 'instead of subserving the fundamental purposes of the statute . . . rather tends to bring about unfortunate if not irrational results.'" *Gonder v. Kelley*, 372 F.2d 94, 95 (9th Cir. 1967) (Koelsch, J., dissenting) (quoting *McIntyre v. Kavanaugh*, 242 U.S. 138, 141 (1916)).

Because the decision below has far-reaching consequences, and in light of the constitutional mandate that bankruptcy law be "uniform," U.S. Const. art. I, § 8, cl. 3, this Court should grant certiorari to resolve the square, and mature conflict among the courts of appeals.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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MARCH 2002

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

IN RE LEONARD L. WARNER AND ARLENE L. WARNER,
Debtors.

A. ELLIOTT ARCHER; CAROL A. ARCHER,
Plaintiffs-Appellants,

v.

ARLENE L. WARNER,
Defendant-Appellee,

AND

LEONARD L. WARNER,
Defendant.

No. 00-2525.

Argued Sept. 27, 2001
Decided March 8, 2002

[--- F.3d ---, 2002 WL 369926]

OPINION

WIDENER, Circuit Judge.

Elliot and Carol Archer appeal from the district court's order affirming the bankruptcy court. The district court held that Arlene Warner's affirmative defense of settlement in a state suit, involving the same facts upon which rest the non-dischargeability claim at issue here, created a novation

substituting a contract debt which was dischargeable for the tort claims which arguably were not. For the following reasons, we affirm.

I.

On May 22, 1992, Warner Manufacturing, Inc. and Leonard L. and Arlene Warner, his wife, the owners thereof, sold the corporate assets of Warner Manufacturing to a corporation formed by the Archers for a total of $685,000.[1] In late 1992, the Archers filed suit in Superior Court of Guilford County, North Carolina against Leonard Warner and Warner Manufacturing for fraudulent misrepresentation and like misconduct arising out of the sale. An amended complaint, filed in the state court in March 1994, asserted fraud, misrepresentation, conspiracy, and fraudulent conveyance, among other claims, and added Arlene Warner and two other parties as named defendants. On May 8, 1995, the Archers again amended their complaint to include intentional and negligent infliction of emotional distress, and asserted that they had suffered mental and emotional distress, pain and suffering, and loss of enjoyment of life as a consequence of the Warners' alleged acts. Three days later, on May 11, after extensive pre-trial discovery, the parties settled the state court litigation.

The settlement consisted of an agreement, an addendum to the agreement, two releases, a promissory note, and two deeds of trust. The settlement agreement provided that the Archers would receive $300,000, consisting of a $200,000 cash payment which was paid, and a $100,000 promissory note to be paid in two installments over the next year. The agreement stated that the willingness of the Archers to resolve the case stemmed from both the non-taxable nature of a part of the consideration for the settlement and the

[1] The assets of Warner Manufacturing sold for $610,000; there was included in the transaction a $70,000 consulting fee to Leonard Warner and a $5000 non-competition agreement.

numerous defenses asserted by the Warners. An addendum to the settlement agreement specified that the agreement would be declared null and void if the criminal charges pending against Leonard Warner were not dismissed by the State of North Carolina. The promissory note, from Leonard and Arlene Warner and Hosiery Industries, Inc., was secured by two deeds of trust--one on the Warners' home and another on business property owned by Hosiery Industries, Inc. The Warners received both a general and mutual release of all pending and future claims by the Archers. Specifically, the general release stated the Archers "do hereby release and forever discharge the ... [Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of the litigation in Guilford County Superior Court, File No. 92-CVS-7777...." In both releases, neither party admitted liability or wrongdoing; moreover, specific clauses stated that the payment of money should not be construed as an admission of liability. There was no mention of bankruptcy in the settlement package.

On November 11, 1995, the first payment on the $100,000 promissory note became due. When the Warners defaulted on this payment, the Archers sued in Superior Court in Guilford County on December 4, 1995.[2] The suit was for collection on the note. On February 5, 1996, while this collection suit was still pending, Leonard and Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code, which was converted to a case under Chapter 7 on October 29, 1996. The present dispute originated on January 29, 1997 when the Archers filed an adversary proceeding in the United States Bankruptcy Court for the Middle District of North Carolina, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness was non- dischargeable under Section 523(a) of

[2] The second payment was due on May 11, 1996. The Warners defaulted on this payment as well, being in bankruptcy.

the Bankruptcy Code, 11 U.S.C. § 523(a). As grounds for asserting the non-dischargeability of this indebtedness, the Archers incorporated by reference in the bankruptcy adversary complaint the multiple allegations contained in their suit in the state court.[3] These were the only grounds there stated for asserting non-dischargeability.[4] Defendant

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[3] In the Archers' adversary complaint to determine dischargeability of debt, Section 13 of the complaint states:

> Plaintiffs expressly incorporate by reference the terms and conditions of the Amended Complaint plaintiffs filed against defendants in Guilford County Superior Court, case no. 92-CVS-7777, setting forth causes of action for, among other matters, fraud, misrepresentation, conspiracy to defraud, conspiracy to take plaintiffs' property by false pretenses in violation of criminal statute G.S. § 14-100, and, in general, for deliberate, intentional, willful, wanton, malicious, and wrongful acts of defendants in an elaborate scheme by which defendants took hundreds of thousands of dollars from plaintiffs by false pretenses.

[4] The Archers attempted later to claim fraud-in-the-inducement of the settlement as well. On June 25, 1998 the Archers moved to amend their adversary complaint to show, among other things, that Mrs. Warner had committed fraud when she and her husband induced the Archers to accept the $100,000.00 note. The proposed amended complaint was filed with the motion, but, when the motion came on for hearing, no attorney appeared for either side and the bankruptcy court justifiably denied the motion to amend the complaint, a plaintiff's motion for discovery, and a motion by Arlene Warner for summary judgment. This order was filed October 6, 1998.

On February 2, 1999 the court set the adversary proceeding for trial on June 1, 1999, and on May 27, 1999 the Archers renewed their motion to amend the complaint. The trial having been continued at the instance of the Archers, the pending motions to amend the complaint came on before the bankruptcy court for hearing on June 1, 1999, along with other motions and objections by both the Archers and Mrs. Warner, all of whom were represented by their attorneys at that hearing. The court denied all of the motions and its order filed June 2, 1999 provided as the reasons: "For the reasons stated in open court." Among the motions denied was the renewed motion to amend the complaint. Although the reasons were stated in open court, they are not included in the record in

Arlene Warner denied any misconduct on her part and asserted an affirmative defense of settlement of the original state court suit.[5] She argued that the Archers may not rely

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this case, and we are left to speculate as to what they were. We are asked to decide, in effect, that the bankruptcy court abused its discretion when it did not permit the amendment of the complaint in the adversary proceeding.

A reading of the amended complaint presented to the bankruptcy court on May 27, 1999 does not charge any fact that Mrs. Warner misrepresented to the Archers, unless it be that she and her husband could only borrow or otherwise come up with $200,000.00 of the agreed $300,000.00 settlement, leaving $100,000.00 to be paid under the note, as has been mentioned before. While the Archers now argue that the reason the note is not dischargeable in bankruptcy is because Mrs. Archer intended at the outset not to pay it, that reason was not presented to the bankruptcy judge in the amended complaint at the hearing on June 1, 1999 resulting in the June 2, 1999 order.

While the amended complaint contains many conclusions charging fraudulent or like conduct against Mrs. Warner, a reading of that paper does not contain sufficient factual allegations for us to conclude that the bankruptcy court abused its discretion when it did not permit the amendment. In that respect, we note that the prayer of the amended complaint includes the following:

> 5. That in the alternative, if defendant Arlene Warner's obligation to plaintiffs is determined to be discharged in Bankruptcy, that plaintiffs be declared released from any agreement and obligation to take no action to cause criminal proceedings to be brought against Arlene Warner or her son, Stuart Warner.

That aspect of the prayer alone would seem to be sufficient reason to justify the action of the bankruptcy court in denying the sought for amendment of the complaint, but, again, since the record does not disclose the reasons, we decline to find the bankruptcy court abused its discretion in its denial of the motion to amend the complaint, and do not speculate as to its reasons.

[5] Arlene Warner contested this issue of non-dischargeability in the bankruptcy court. We are told her husband, Leonard Warner, did not. No issue with respect to the liability of Leonard Warner is before this court on appeal, and, again, we are told that the Warners are divorced.

upon the same alleged misconduct in the original suit in the state court as grounds for non-dischargeability because that suit was settled *in toto*.

On August 24, 1999 the bankruptcy court had ordered the trial bifurcated, first hearing issues on what it called the affirmative defense.[6] On August 26, 1999 the case was tried on the affirmative defense of the dischargeability action. The bankruptcy court decided in favor of Mrs. Warner, upholding her affirmative defense. The Archers appealed this decision contending that the bankruptcy court misinterpreted the exception to dischargeability under 11 U.S.C. § 523(a)(2)(A). The district court affirmed the bankruptcy court's decision. It concluded that the releases and settlement agreement created a novation, substituting a dischargeable contract debt for a fraud-based tort claim which may not have been dischargeable. The district court continued by holding that the argument of fraud-in-the-inducement of the settlement agreement was not properly before the court because such claim was not presented to or decided by the bankruptcy court. Nevertheless, the district court commented that any successful fraud-in-the-inducement contention must establish that Mrs. Warner planned all along to file bankruptcy to escape her contractual settlement commitments with the Archers. The district court doubted such a plan because the Warners had ready paid $200,000 in cash pursuant to the settlement agreement, and had given deeds of trust on real estate to secure the payment of the note as well. In any event, because of the novation which we affirm, see *infra*, and our

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6 As previously noted, the Archers' motion to amend their complaint was last denied by the bankruptcy court on June 2, 1999. Whether the bankruptcy court has foreclosed such a claim is a question we do not decide. The bankruptcy court called for trial the issue presented here, which was whether the settlement agreement effected a novation of the dischargeability claim which might have existed into a claim upon the settlement which does exist. No evidence was offered in the bankruptcy court as to fraudulently inducing the settlement.

opinion that the Archers have not shown an abuse of discretion by the bankruptcy court in its refusal to permit the amendment to the adversary complaint, that is a contention upon which we express no opinion.

II.

We have jurisdiction to hear this case under 28 U.S.C. § 158(d). This court "reviews the judgment of a district court sitting in review of a bankruptcy court de novo, applying the same standards of review that were applied in the district court." *In Re Biondo*, 180 F.3d 126, 130 (4th Cir.1999).[7] Specifically, we review the factual findings of the bankruptcy court for clear error, while we review questions of law de novo. *In Re Biondo*, 180 F.3d at 130.

The pertinent bankruptcy code, 11 U.S.C. § 523, provides:

> § 523. Exceptions to discharge
>
> (a) A discharge under section 727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt....
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting debtor's or an insider's financial condition; ...
>
> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity....

The issue we address is whether the district court erred in determining that a prepetition settlement of claims involving the same claims pursued here, alleged fraud or intentional tort, extinguished the Archers' subsequent non-

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7 We note in passing that the Archers do not depend on *Biondo*.

dischargeability claims under Section 523(a)(2)(A) when Mrs. Warner filed for bankruptcy relief without having paid the settlement promissory note. As noted by the district court, there is a split among the circuits concerning this issue. Under one line of cases, a settlement agreement does not distinguish a dischargeability claim under Section 523(a). See *United States v. Spicer*, 57 F.3d 1152 (D.C.Cir.1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir.1983). According to this line of cases, examining the underlying fraudulent allegations leading to the settlement agreement best effectuates Congressional policy by its construction of the statutes as not permitting the discharge of debts that Congress intended to survive bankruptcy. *Greenberg v. Schools*, 711 F.2d 152 (11th Cir.1983). The opposing line of cases favors the basic principle of encouraging settlements by way of freedom to enter into settlement agreements, regardless of the nature of the claim subject to the settlement agreement. See *In re Fischer*, 116 F.3d 388 (9th Cir.1997); *In re West*, 22 F.3d 775 (7th Cir.1994); *Maryland Casualty Co. v. Cushing*, 171 F.2d 257 (7th Cir.1948). Under this theory, parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise, the incentive to settle is gone.

We agree with the district court and the bankruptcy court that the better reasoned decisions are those of the Seventh and Ninth Circuits rather than those of the District of Columbia and Eleventh Circuits. So we follow *West*, *Md. Casualty*, and *Fischer*. We are of opinion that Congress did not intend that 11 U.S.C. § 523(a) be construed, as a reversal here would require, so as to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a).

When following the novation theory,[8] the terms of the settlement should be examined to determine whether the non-dischargeability claims under Section 523(a)(2)(A) were released. The Archers would have us hold that courts must determine whether the underlying factual basis for the settlement agreement consisted of fraud; however, under the novation theory, courts need only address the validity and completeness of the bargained for agreement and release. We review these factual issues for clear error.

The settlement package, consisting of the settlement agreement with addendum, two releases, a promissory note, and two deeds of trust, completely released Arlene Warner from potential non-dischargeability claims under Section 523(a)(2)(A). The settlement agreement referred explicitly to the general and mutual releases. The general release further announced the complete waiver of all pending and future related personal claims against Arlene Warner. It provides that the Archers

> do hereby release and forever discharge the [Warners] from any and every right, claim, or demand ... arising out of or relating to the matter in Guilford County Superior Court, excepting only obligations under a Note and deeds of trust executed contemporaneously herewith.

This release continued by specifying the claims released:

> The payment of the sum of $300,000 ... is paid to [the Archers] in settlement of their personal claims for emotional distress/personal-injury-type damages they claim to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction

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8 While novation is sometimes interpreted to mean the replacement of a third party to an existing contract, see *Black's Law Dictionary*, 7th Ed., 1999, p. 1091, we, like the Ninth Circuit, use the term in the context of § 523(a)(2)(A) to express the substitution of a contract claim for a tort claim through a settlement agreement, the Seventh Circuit use.

> of emotional distress, and negligent infliction of emotional distress. The parties further acknowledge that all sums set forth above constitute payment for claims of damages resulting from personal injuries or sickness or mental and emotional distress in a case involving prosecution of a legal suit or action based upon tort or torttype rights....

As noted in *West*, "A promissory note does not discharge the underlying obligation unless the parties expressly release the old and substitute the new." *West*, 22 F.3d at 778. The settlement agreement and promissory note here, coupled with the broad language of the release, completely addressed and released each and every underlying state law claim.

We therefore follow *Fischer*, *West*, and *Md. Casualty* and affirm the judgment of the district court that the prepetition settlement of claims involving alleged fraud and intentional tort extinguished the Archers' subsequent non-dischargeability claim under Section 523(a) when Mrs. Warner filed for bankruptcy relief without having paid the entire amount of the settlement.

The judgment of the district court is accordingly

AFFIRMED.

TRAXLER, Circuit Judge, dissenting.

A unanimous Supreme Court reminded us as recently as four years ago that "[t]he Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.' " *Cohen v. de la Cruz*, 523 U.S. 213, 217, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998) (quoting *Grogan v. Garner*, 498 U.S. 279, 287, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991)). To this end, "Congress intended the fullest possible inquiry"

into the nature of debts for purposes of determining dischargeability. *Brown v. Felsen*, 442 U.S. 127, 138, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979). Because I believe the approach employed by the D.C. and Eleventh Circuits in *United States v. Spicer*, 57 F.3d 1152 (D.C.Cir.1995), and *Greenberg v. Schools*, 711 F.2d 152 (11th Cir .1983) (per curiam), ultimately accomplishes the congressionally enacted policy objective embodied in the nondischargeability provisions, I respectfully dissent.

I.

There are two competing views to the main issue in this case and both have much to commend them. The bankruptcy court adopted the approach of the Ninth and Seventh Circuits reflected in *In re West*, 22 F.3d 775 (7th Cir.1994), and *Key Bar Invs., Inc. v. Fischer* (*In re Fischer*), 116 F.3d 388 (9th Cir.1997) (per curiam). The analysis employed in those cases is best illustrated by the test articulated by the Ninth Circuit in *Fischer*: "[I]f it is shown that the [promissory] note, by express agreement is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action and it would be error for the court to look behind the note." *Fischer*, 116 F.3d at 390 (internal quotation marks omitted); *accord West*, 22 F.3d at 778 ("[I]f it is shown that the [promissory] note [that was executed pursuant to the settlement] was given and received as payment or waiver of the original debt and the parties agreed that the note was to substitute a new obligation for the old, the note fully discharges the original debt, and the nondischargeability of the original debt does not affect the dischargeability of the obligation under the note."). The basic rationale of these cases is that, having accepted a settlement and released the underlying tort action, the plaintiff voluntarily accepted a contract debt, which is dischargeable under the bankruptcy laws, in lieu of pursuing a potentially non-dischargeable tort debt.

The competing approach adopted by the D.C. and Eleventh Circuits in *Spicer* and *Greenberg* can be quickly illustrated by examining *Spicer*. In that case, John Spicer had been convicted of one count of interstate transportation of money obtained by fraud from the United States Department of Housing and Urban Development and had thereafter settled the government's multiple civil claims against him. In accord with the civil settlement agreement, Spicer executed two promissory notes and the government expressly released its civil claims against him. Spicer later filed for bankruptcy protection and, relying on *West*, sought to have the promissory notes discharged. Addressing *West* directly, the D.C. Circuit declared that it could not "agree with a rule under which, through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a non-fraudulent one, and thereby immunize himself from the strictures of § 523(a)(2)(A)." *Spicer*, 57 F.3d at 1155. The court found the government's release of the underlying tort action immaterial, declaring that "a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress ..., merely by altering the *form* of his debt through a settlement agreement." *Id.* at 1156. Accordingly, the court affirmed the bankruptcy court's holding that the promissory notes executed by Spicer were not dischargeable. *Id.* at 1157. Thus, simply stated, the *Spicer* approach is a policy-based approach intended to effectuate the considered judgment of Congress.

II.

The Archers urge us to adopt the *Spicer* approach and allow them the opportunity to prove in bankruptcy court that Arlene Warner committed fraud against them and that the promissory note executed as part of the settlement of the state-court tort action is therefore nondischargeable under § 523(a)(2)(A). In my judgment, Supreme Court precedent strongly suggests that the *Spicer* approach is the correct one.

In 1979, for example, the Supreme Court decided *Brown*. In that case, G. Garvin Brown had been guarantor of a loan that financed Mark Paul Felsen's business. When the creditor instituted a collection action against Brown and Felsen, Brown filed a counterclaim against Felsen alleging that Felsen had induced Brown to sign the guarantee "by misrepresentations and non-disclosures of material facts." *Brown*, 442 U.S. at 128 (internal quotation marks omitted). The suit settled and was reduced to a consent judgment indicating that Brown should have judgment against Felsen but not indicating the cause of action upon which the liability was based or whether Felsen had in fact engaged in fraud. Felsen subsequently filed for bankruptcy, and Brown sought to challenge in bankruptcy court the dischargeability of Felsen's debt to him. Felsen argued that because the state-court suit had been reduced to a consent judgment and the documents evidencing that judgment did not result in a finding that he had in fact committed fraud, res judicata barred further inquiry into the nature of the debts. Gleaning from the legislative history of the Bankruptcy Act "[s]ome indication that Congress intended the fullest possible inquiry" into the true nature of debts for purposes of determining dischargeability, the Supreme Court unanimously rejected that argument. *Id.* at 138. After "careful inquiry," the Court concluded that "the policies of the Bankruptcy Act" would best be served by allowing Brown to "submit[ ] additional evidence to prove his case." *Id.* at 132.

Twelve years after *Brown*, the Supreme Court was asked in *Grogan* to resolve a circuit split on the question of whether, in bankruptcy court, a creditor was required to prove the nondischargeability of his claim by a preponderance of the evidence or by clear and convincing evidence. The Court unanimously found that the preponderance standard best reflected the "congressional decision to exclude from the general policy of discharge certain categories of debts--such as ... liabilities for fraud," and the Court therefore held that a creditor need only prove

that his claim was nondischargeable under the preponderance standard. *Grogan*, 498 U.S. at 287. "We think it unlikely," the Court declared, "that Congress, in fashioning the standard of proof that governs the applicability of these provisions, would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud." *Id.*

And finally, in 1998, in *Cohen*, a unanimous Supreme Court yet again stressed the importance of reinforcing the congressional policy objective underlying the nondischargeability provisions. In *Cohen*, the Court decided that a treble damages award that was imposed as punishment for a state-court defendant's fraudulent conduct was non-dischargeable under the fraud exception to dischargeability, rejecting the debtor's argument that only an amount equal to the actual value obtained by fraud should be nondischargeable. *Cohen*, 523 U.S. at 219. In support of its decision, the Court cited "the historical pedigree of the fraud exception, and the general policy underlying the exceptions to discharge." *Id.* at 223.

Thus, the message delivered by a unanimous Supreme Court on three separate occasions has been clear. In deciding cases dealing with the fraud exceptions to dischargeability, courts should effectuate congressional policy objectives by conducting the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor. The *Spicer* approach is squarely grounded in these policy interests.

Under any other approach, a defendant can completely immunize himself from § 523 by simply settling any fraud claims against him with a promise to pay, having the plaintiff release the underlying tort action as part of the settlement, and then filing for bankruptcy. The acceptance of the defendant's promise to make payment should not prevent the plaintiff, upon a default by the defendant and subsequent filing of bankruptcy, from showing the bankruptcy court that

the debt had its genesis in fraud. If, as the Supreme Court has declared, "the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt," *Brown*, 442 U .S. at 138, then I see no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry. *See Ed Schory & Sons, Inc. v. Francis* (*In re Francis*), 226 B.R. 385, 391 (B.A.P. 6th Cir.1998) (choosing to "follow [ ] *Spicer* because *Brown v. Felsen* compels the *Spicer* result"); *see also Giaimo v. Detrano* (*In re Detrano*), 266 B.R. 282, 288 (E.D.N.Y.2001) (finding *Brown* "[i]nstructive"). Moreover, because the nondischargeability provisions of the Bankruptcy Code evidence a considered congressional policy to favor "the interest in protecting victims of fraud" over "the interest in giving perpetrators of fraud a fresh start," *Grogan*, 498 U.S. at 287, and because the Supreme Court has so strongly and unwaveringly signalled through three uninamimous opinions over the course of twenty years that that policy objective is to be jealously protected, I would adopt the *Spicer* approach.* *Cf. Foley & Lardner v. Biondo* (*In re Biondo*), 180 F.3d 126, 130 (4th Cir.1999) (noting the importance of "ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code").

III.

For these reasons, I would elevate substance over form and allow the Archers to offer such proof as they might have to show that Arlene Warner's debt resulted from a fraud perpetrated upon them. Therefore, I respectfully dissent.

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* I do not view the settlement documents as forbidding the Archers from proving in bankruptcy court the nondischargeability of the debt because, among other things, the releases specifically excepted the Warners' obligations under the promissory note and deeds of trust, (J.A. 45, 48), which I would interpret as permitting a full and fair hearing on the dischargeability of the debt in bankruptcy court.

APPENDIX B

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

LEONARD L. WARNER and ARLENE L. WARNER,
Debtors.

Adversary Proceeding No. A-97-2003
Bankruptcy Proceeding No. B-96-10373 C-7G

A. ELLIOTT ARCHER and CAROL A. ARCHER,
Appellants,

v.

ARLENE L. WARNER,
Appellee.

Civil Action No. 1:99CV00924

[FILED: Sept. 27, 2000]

MEMORANDUM OPINION

BULLOCK, District Judge

This case comes before the court on appeal, pursuant to 28 U.S.C. § 158(a), from an order of the United States Bankruptcy Court for the Middle District of North Carolina. Appellants, A. Elliott Archer and Carol A. Archer (the "Archers"), appeal an order of the bankruptcy court entering judgment in favor of Appellee, Arlene L. Warner ("Warner"), on the Archers' **[Page 2]** non-dischargeability

action under Section 523(a)(2) of the Bankruptcy Code. For the following reasons, the court will affirm the order of the bankruptcy court.

FACTS

Because the facts are fully set out in the bankruptcy court's memorandum opinion, a brief summary will suffice.

On May 22, 1992, a corporation formed by the Archers purchased the assets of a company known as Warner Manufacturing, Inc., for the price of $610,000.00 plus payment of a consulting fee to Leonard L. Warner in the amount of $70,000.00 and the sum of $5,000.00 for a related non-compete agreement. In late 1992, the Archers instituted a suit in the General Court of Justice, Superior Court Division, Guilford County, North Carolina, against Warner Manufacturing, Inc., and Leonard Warner alleging fraudulent misrepresentation arising out of the asset-purchase agreement. Thereafter, in March 1994, the Archers filed an amended complaint, adding Arlene Warner and two other parties as named defendants and asserting claims for breach of contract, fraud and misrepresentation, conspiracy, fraudulent conveyance, and unfair and deceptive trade practices. The Archers also sought to pierce the corporate veil of Warner Manufacturing, **[Page 3]** Inc., and to establish a constructive trust. The amended complaint specifically alleges that Arlene Warner was involved in the fraud and other misconduct. On May 8, 1995, the Archers amended their complaint again to designate their second claim as being one for fraud, misrepresentation, and intentional and negligent infliction of emotional distress.

On or about May 11, 1995, after extensive pre-trial discovery, the parties were able to reach a settlement. Pursuant to the written settlement agreement, the Archers were to receive the sum of $300,000.00, consisting of a cash payment of $200,000.00 and a promissory note for the principal sum of $100,000.00. The Archers were paid the

$200,000.00 in cash and the remainder as a $100,000.00 promissory note from Leonard L. Warner, Arlene Warner, and Hosiery Industries, Inc. The Archers also received two deeds of trust securing the promissory note. Pursuant to the settlement agreement, the Archers executed and delivered to Arlene Warner a general release and a mutual release which Arlene Warner similarly executed. On May 15, 1995, the Archers dismissed with prejudice the state court suit against Arlene Warner.

The $100,000.00 promissory note which the Archers received in the settlement was payable in two payments, the first due on November 11, 1995, and the second due on May 11, 1996. When the **[Page 4]** November payment was not made, the Archers brought suit on the promissory note in the General Court of Justice, Superior Court Division, Guilford County, North Carolina, on December 4, 1995. This suit for collection on the promissory note was still pending when Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code on February 5, 1996. Several months later, Arlene Warner's Chapter 13 case was converted to Chapter 7. Thereafter, the Archers filed this proceeding in United States Bankruptcy Court for the Middle District of North Carolina on January 29, 1997, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness is non-dischargeable under Section 523(a) of the Bankruptcy Code.

In their complaint in the bankruptcy proceeding, the Archers incorporated by reference the allegations of fraud, misrepresentation, conspiracy and the like from their original state court action against the Warners as grounds for asserting that the indebtedness due under the promissory note was non-dischargeable. Arlene Warner answered these allegations by denying any misconduct on her part and asserting an affirmative defense that the settlement of the original suit was a settlement of a disputed claim and did not constitute an admission of fraud or of liability.

[Page 5] Prior to trial, the bankruptcy court ordered that the trial be bifurcated and that the issues involved in the affirmative defense be tried first. On August 26, 1999, the dischargeability action was called for trial and the bankruptcy court received evidence and heard arguments of the parties. The bankruptcy court concluded that the affirmative defense raised by Arlene Warner should be upheld and that judgment should be entered in her favor. The Archers appeal, contending that the bankruptcy court misinterpreted the exception to dischargeability under Section 523(a)(2)(A) and did not allow them an adequate opportunity to present evidence of fraud in the underlying business transaction or fraud in the inducement of the settlement agreement.

DISCUSSION

The district court "review[s] the bankruptcy court's factual findings for clear error, while ... review[ing] questions of law de novo." In re K&L Lakeland, Inc., 128 F.3d 203, 206 (4th Cir. 1997). When addressing exceptions to discharge, a district court should "interpret the exceptions narrowly to protect the purpose of providing debtors a fresh start." In re Biondo, 180 F.3d 126, 130 (4th Cir. 1999) (citing Century 21 Balfour Real **[Page 6]** Estate v. Meanna, 16 F.3d 7, 9 (1st Cir. 1994). However, district courts should be "equally concerned with ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code." Id. (citing Cohen v. Cruz, 523 U.S. 213 (1998)).

The issue raised on appeal, as correctly framed by the bankruptcy court, is "whether a prepetition settlement of claims involving alleged fraud and intentional infliction of injury can extinguish the plaintiff's subsequent nondischargeability claim under § 523(a) when the defendant files for bankruptcy relief without having paid the entire amount of the settlement." (Mem. Op. at 6). Section 523(a)(2)(A) of the Bankruptcy Code, excepts from

discharge any debt obtained by fraud, false pretenses, or a false representation in writing, other than a false representation concerning the financial condition of the debtor or an insider. See 11 U.S.C. § 523(a)(2)(A). To establish that a debtor engaged in actual fraud making the obligation non-dischargeable under Section 523(a)(2)(A), the creditor must prove four elements: (1) a fraudulent misrepresentation; (2) that induces another to act or refrain from acting; (3) causing harm to the creditor; and (4) the creditor's justifiable reliance on the misrepresentation. See In re Biondo, 180 F.3d at 135.

[Page 7] In the context of a non-dischargeability proceeding brought pursuant to Section 523(a)(2)(A), there presently exists a split of authority as to whether a subsequent promissory note accompanied by a settlement agreement containing a general release executed by the creditor makes an otherwise non-dischargeable debt a dischargeable one. The case law is sharply split on this issue, and the Fourth Circuit offers little guidance. However, an examination of these various non-binding authorities reveals that the bankruptcy court correctly concluded that the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy.

In the Seventh and Ninth Circuits, a debt that otherwise would have been non-dischargeable becomes fully dischargeable when an instrument such as a note, release, or waiver substitutes a contractual obligation for the obligation arising from tortious acts. In re Fisher, 116 F.3d 388 (9th Cir. 1997); In re West, 22 F.3d 775 (7th Cir. 1994). Courts in other jurisdictions have arrived at different conclusions on this issue. The Eleventh Circuit held under Section 523(a)(4) that "a debt which originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement." **[Page 8]** Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983). The District of Columbia

Circuit followed Greenberg in a Section 523(a)(2)(A) context, noting that such an approach effectuates congressional policy by denying the nefarious debtor a fresh start at the expense of innocent third parties. United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995). Similarly, the bankruptcy appellate panel of the Sixth Circuit has recently held that, for bankruptcy purposes, a novation does not extinguish the underlying fraud or debt. See In re Francis, 226 B.R. 385, 389-91 (6th Cir. 1998).

As an initial matter, this case involves facts markedly similar to West and it is readily distinguishable factually from Greenberg, Spicer, and Francis. The settlement agreement in Greenberg did not include a waiver and release of the underlying fraud claim, while the settlement agreement in the instant case contains such a release from further liability. As the bankruptcy court noted, the settlement documents in this case make it clear that the claims which were being settled by the parties included claims based on fraud, misrepresentation, and other alleged intentional misconduct on the part of Arlene Warner. The general release provided that the Archers would release and forever discharge Arlene Warner from "any and every right, claim, or demand which [the Archers] now have or might **[Page 9]** otherwise hereafter have against [Arlene Warner] arising out of or related to the matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and Deeds of Trust executed contemporaneously herewith." (Mem. Op. at 9). Spicer was a post-conviction settlement while the present case involved a pre-litigation settlement. Here, there had been no determination of fraud or even a presentation of evidence on the issue at the time of settlement. In re Francis contained an admission of fraud on the part of the debtor while this case contains no such acknowledgment of wrongdoing. In the present case, as in West, the settlement agreement contained a complete release, it was a pre-litigation settlement, and there was no admission of fraud on the part of the debtor. Accordingly, the factual

setting in which the disputed legal issue is presented strongly suggests the application of In re West and In re Fisher rather than Greenberg, Spicer, and In re Francis.

A recent district court case, In re Detrano, 222 B.R. 685 (Bankr. E.D.N.Y. 1998), involves facts quite similar to this case and addresses the legal issue in a persuasive manner. In Detrano, the court held that the debtor's execution of a promissory note in settlement of pending fraud litigation replaced the fraud claim with a contract debt dischargeable in **[Page 10]** bankruptcy. The bankruptcy court elected to follow West rather than Spicer, explaining its reasoning as follows:

> This court is not at all persuaded that Spicer's medieval imagery of alchemy is particularly helpful in determining this issue. Indeed, the line of decisions reflected in Spicer begs the fundamental question and, worse, undermines the entire structure of incentives for settling tort claims in state court. What Spicer ignores is that there is usually a tremendous distance between pleading and proving intentional torts. Until the allegations are proven by clear preponderance of the evidence (or admitted to), there is no basis for presuming the defendant is an intentional tortfeasor for purposes of either state law or federal bankruptcy law. A settlement in which both parties are represented by competent counsel, and which is approved by a court of competent jurisdiction, should render those allegations entirely moot--not because the defendant is or is not a bad man, but because the parties have mutually agreed that issue will not be litigated. There is absolutely nothing about federal bankruptcy law that should disturb that state law outcome.

222 B.R. at 688.

The result reached in the West line of cases is bolstered by the fact that there are several reliable ways to ensure that a debt for fraud does not become dischargeable in bankruptcy after the parties settle the claim: (1) the creditor can make the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement, Detrano, 222 B.R. at 689; (2) the creditor can make the debtor acknowledge that any release of liability is conditional until full payment is made, id.; and (3) the settlement agreement can be subject to plaintiff's right **[Page 11]** to assert non-dischargeability in a bankruptcy proceeding. If the risk associated with the potential for bankruptcy is greater than the risk associated with the uncertain outcome at trial, the creditor always has the option of going forward and seeking to secure a judgment of fraud against the debtor. The Archers contend that a pre-petition settlement of a fraud claim cannot alter the nature of the obligation so as to extinguish a subsequent dischargeability claim under Section 523(a)(2)(A). However, this argument merely begs the question of why parties cannot bargain to account for the contingencies of liability in any given case. As Judge Lundin, the dissenter in Francis, observed,

> [T]here is no analogous provision of federal law that conditions or prohibits enforcement in bankruptcy of a creditor's prepetition agreement to release its cause of action under § 523(a)(2). Put another way, nothing in the Bankruptcy Code interrupts the ordinary capacity of creditors under nonbankruptcy law to contract for the release of claims that are or might be nondischargeable in bankruptcy. As recognized by the Seventh and Ninth Circuits, if enforceable under state law, a creditor's prepetition release of a potential cause of action under § 523 of the Bankruptcy Code precludes that creditor's § 523 complaint without regard to the merits of the underlying dispute.

226 B.R. at 393. In dismissing the Francis majority's reliance on public policy as a basis for its decision, Judge Lundin responded that the majority actually did the public a disservice by remov[ing] a major incentive for debtors to settle with **[Page 12]** creditors before bankruptcy and [thereby] impos[ing] a previously unrecognized 'bankruptcy penalty.' A debtor willing to give valuable collateral to a prebankruptcy victim in exchange for release of potentially nondischargeable personal liability bargains for a worthless promise under the Panel's rule." 226 B.R. at 395.

The Archers' procedural argument also fails in that they did not object to the bankruptcy court's severance of the case and ruling first on the affirmative defense raised by Arlene Warner. Therefore, only the bankruptcy court's determination on that issue is before this court. Regardless, the Archers' fraud-in-the-inducement argument would have to overcome the substantial hurdle of showing that the Warners planned all along to file bankruptcy to extinguish their debt, despite the fact that $200,000.00 of the $300,000.00 settlement amount was paid in cash at the time of settlement.

The decision of the bankruptcy court will be affirmed. An order and judgment in accordance with this memorandum opinion shall be entered contemporaneously herewith.

September 27, 2000

/s/ Frank W. Bullock, Jr.
United States District Judge

APPENDIX C

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

LEONARD L. WARNER and ARLENE L. WARNER,
Debtors.

Adversary Proceeding No. A-97-2003
Bankruptcy Proceeding No. B-96-10373 C-7G

A. ELLIOTT ARCHER and CAROL A. ARCHER,
Appellants,

v.

ARLENE L. WARNER,
Appellee.

Civil Action No. 1:99CV00924

[FILED: Sept. 27, 2000]

ORDER and JUDGMENT

BULLOCK, District Judge

For the reasons set forth in the memorandum opinion filed contemporaneously herewith,

IT IS ORDERED AND ADJUDGED that the judgment of the Bankruptcy Court is **AFFIRMED**, and this appeal is **DISMISSED**.

September 27, 2000

/s/ Frank W. Bullock, Jr.
United States District Judge

APPENDIX D

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

Leonard L. Warner and Arlene L. Warner,
Debtors.

Case No. 96-10373C-7G

A. Elliott Archer and Carol Archer,
Plaintiffs,

v.

Leonard L. Warner and Arlene L. Warner,
Defendants,

Adversary No. 97-2003

[Entered: Aug. 30, 1999]

MEMORANDUM OPINION

This dischargeability action came before the court for trial on August 26, 1999. Harry G. Gordon appeared on behalf of the plaintiffs and Rayford K. Adams, III appeared on behalf of defendant Arlene L. Warner. Having considered the evidence offered by the parties, the findings and conclusions of the court pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure are hereinafter set forth.

JURISDICTION

The court has jurisdiction over the subject matter of this **[Page 2]** proceeding pursuant to 28 U.S.C. §§ 151, 157 and 1334, and the General Order of Reference entered by the United States District Court for the Middle District of North Carolina on August 15, 1984. This dischargeability action is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2)(I) which this court may hear and determine.

FACTS

This litigation arose out of a business transaction which occurred in 1992 in which a corporation formed by the plaintiffs agreed to purchase the assets of a company known as Warner Manufacturing, Inc. for a price of $610,000.00, plus payment to Leonard Warner of a consulting fee of $70,000.00 and the sum of $5,000.00 for a non-compete agreement. The closing on the purchase occurred on May 22, 1992. The plaintiffs contend that numerous fraudulent misrepresentations were made by Leonard Warner during the negotiations which they relied upon in entering into the asset purchase agreement.

During the latter part of 1992 plaintiffs instituted a suit in the Superior Court of Guilford Count against Warner Manufacturing, Inc. and Leonard Warner. In March of 1994 the plaintiffs filed an amended complaint in which Arlene Warner and two other parties were **[Page 3]** added as defendants. The amended complaint contained claims for breach of contract, fraud and misrepresentation, conspiracy, a claim to pierce corporate veil, fraudulent conveyance, unfair and deceptive trade practices and constructive trust. The amended complaint alleges that both Leonard Warner and Arlene Warner were involved in the fraud and other misconduct alleged in the amended complaint. On May 8, 1995, shortly before the state court litigation was settled, the plaintiffs amended their complaint again to designate their second claim as being one for fraud, misrepresentation and

intentional and negligent infliction of emotional distress, and to add a paragraph asserting that plaintiffs had suffered mental and emotional distress, pain and suffering and loss of enjoyment of life as a consequence of the intentional and negligent acts of the defendants.

On or about May 11, 1995, after extensive pre-trial discovery, the parties to the state court litigation reached a settlement. Pursuant to this settlement the plaintiffs were to receive the sum of $300,000.00, consisting of a cash payment of $200,000.00 and a promissory note for the principal sum of $100,000.00. The parties entered into a written settlement agreement and consummated the settlement on or about May 11, 1995. The plaintiffs were paid the **[Page 4]** $200,000.00 cash payment and a $100,000.00 promissory note from Leonard L. Warner, Arlene Warner and Hosiery Industries, Inc. was delivered to the plaintiffs. The plaintiffs also received two deeds of trust securing the promissory note. Pursuant to the settlement agreement the plaintiffs executed and delivered to defendants a general release and a mutual release which also was executed by the defendants. On May 15, 1995, the plaintiffs dismissed the state court suit against the defendants with prejudice.

The $100,000.00 promissory note which the plaintiffs received in the settlement was payable in two payments, one due on November 11, 1995, and the other due on May 11, 1996. When the November payment was not made, plaintiffs brought suit on the promissory note in the Superior Court of Guilford County on December 4, 1995. This suit on the promissory note was still pending when Leonard Warner and Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code on February 5, 1996. After several months defendants' Chapter 13 case was converted to Chapter 7. Thereafter, this adversary proceeding was filed on January 29, 1997, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness is **[Page 5]** under § 523(a) of the Bankruptcy

Code. In the complaint in this adversary proceeding the plaintiffs incorporate by reference the allegations of fraud, misrepresentation, etc., contained in the complaint in their original suit against the defendants as the grounds for asserting that the indebtedness due under the promissory is nondischargeable. Defendant Arlene Warner answered these allegations with a denial of any misconduct on her part and an affirmative defense in which she asserted that, based upon the settlement of the original suit, the plaintiffs may not rely upon the misconduct alleged in the original suit as grounds for asserting that defendant's obligation under the promissory note is nondischargeable under § 523 of the Bankruptcy Code.

Prior to trial, the court ordered that the issues involved in the affirmative defense be severed and tried first. When this action was called for trial on August 26, 1999, the court received the evidence and arguments of the parties regarding the issues involved in the defendant's affirmative defense. For the reasons hereinafter discussed, the court has concluded that the defense raised by the defendant should be upheld and that judgment should be entered in favor of defendant Arlene Warner.

DISCUSSION

Plaintiffs' original action against the defendants **[Page 6]** unquestionably involved claims alleging fraud, misrepresentation, intentional infliction of emotional distress and other acts of misconduct on the part of the defendants. It is evident from the settlement documents that these claims were included in the settlement which was made in May of 1995. For example, the general release which was signed by the plaintiffs specifically provides that the payment by the defendants is "in settlement of [plaintiffs'] personal claims for emotional distress/personal-injury-type damages they claimed to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction of emotional distress,

and negligent infliction of emotional distress." The issue raised by defendant's affirmative defense is whether a prepetition settlement of claims involving alleged fraud and intentional infliction of injury can extinguish the plaintiff's subsequent nondischargeability claim under § 523(a) when the defendant files for bankruptcy relief without having paid the entire amount of the settlement. The case law is sharply split on this issue.

Under one line of cases, a prepetition settlement does not extinguish a subsequent dischargeability claim. These cases reason that a settlement of a fraud claim cannot alter the nature of the **[Page 7]** defendant's obligation and, therefore, even if the settlement includes a general release, the court may inquire into the factual circumstances behind the settlement agreement to ascertain whether the debt was originally derived from fraudulent conduct and should be treated as nondischargeable. Accordi[illegible] to this line of cases, such a result is necessary in order to effectuate the congressional policy underlying the enactment of exceptions to discharge such as § 523(a)(2)(A). E.g., United States v. Spicer, 57 F.3d 1152 (D.C. Cir. 1995); In re Francis, 226 B.R. 385 (6th Cir. BAP 1998); Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983).

Another line of cases recognizes that under some circumstances, a prepetition settlement may have the effect of extinguishing a later dischargeability claim. Under these cases, the general rule is that a promissory note accepted from a party charged with fraud does not discharge the debt for which it was given and does not bar a later dischargeability claim. However, if it is shown that there is a settlement agreement under which the promissory note was given and received as a discharge of the original obligation or tort action then the execution of the note and settlement agreement extinguishes the tort action and the plaintiff is precluded from thereafter going behind the settlement **[Page 8]** in order to assert nondischargeability. E.g., In re

Fischer, 116 F.3d 388 (9th Cir. 1997); In re West, 22 F.3d 775 (7th Cir. 1994); Maryland Casualty Co. v. Cushing, 171 F.2d 257 (7th Cir. 1948). These cases rely upon the terms of the settlement between the parties in deciding whether a prepetition settlement will have the effect of extinguishing a subsequent dischargeability claim. To the extent that this line of cases represents the view that there is no overriding policy underlying § 523 which prevents the bankruptcy court from giving effect to a valid settlement agreement or release which is broad enough to release and extinguish claims under § 523(a), this court concludes that these cases reflect the better reasoned approach, and will adopt this approach in the present case. There is nothing in § 523(a) which can be read as making it unlawful or illegal for a party alleging fraud to enter into a settlement under which that party agrees to release any claim which might arise in the future under § 523. If such a settlement is made by competent parties and there is no fraud or other vitiating circumstances associated with the settlement, then there is no reason why the settlement should not be enforced and upheld according to its terms. Accordingly, the court will look to the terms of the settlement documents which were signed by the **[Page 9]** plaintiffs in the present case in determining whether the settlement precludes the plaintiffs from now asserting that defendant's obligation under the promissory note is non-dischargeable under § 523(a) of the Bankruptcy Code.

As previously observed, the settlement documents make it clear that the claims which were being settled by the parties included claims based upon fraud, misrepresentation and other alleged intentional misconduct on the part of the defendants. The general release which was executed by the plaintiffs describes the claims which the plaintiffs were releasing and extinguishing. Under this document, the plaintiffs agreed to "release and forever discharge" the defendants "from any and every right, claim, or demand which [the plaintiffs] now have or might otherwise hereafter have" against the defendants "arising out of or relating to the

matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and Deeds of Trust executed contemporaneously herewith." It is significant that this broad language includes the release of any claims which the plaintiffs "might otherwise hereafter have" against the defendants. The plaintiffs thus not only were releasing the claims which existed at the time of the settlement, but also released any claims which they **[Page 10]** might have in the future arising out of or relating to the matters alleged in the complaint in their original action.

By including in the release future claims, the court concludes that the plaintiffs effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant under § 523(a)(2)(A) and § 523(a)(4). The plaintiffs were willing to release and extinguish all of their claims, past, present and future, arising out of the matters alleged in the original law suit in exchange for cash of $200,00.00, a $100,000.00 promissory note and two deeds of trust, which they evidently deemed a satisfactory exchange at the time of the settlement. This settlement was made after the plaintiffs and their counsel had the benefit of extensive information developed through prolonged discovery. Having agreed to the settlement and the broad release granted to the defendants, and having received the cash payment of $200,000.00 as well as the promissory note and deeds of trust, the plaintiffs may not now raise the dischargeability claim they now assert based upon the same allegations and claims contained in the complaint in their original action. The dischargeability claim against defendant Arlene Warner therefore must be decided in her favor of the defendant since the only misconduct alleged in this **[Page 11]** action is the same misconduct described in the original complaint which plaintiffs dismissed with prejudice pursuant to the settlement. Accordingly, a judgment will be entered contemporaneously with the filing of this memorandum opinion dismissing this action as to Arlene Warner.

This 30th day of August, 1999.

/s/ William L. Stocks
WILLIAM L. STOCKS
United States Bankruptcy Judge

APPENDIX E

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

Leonard L. Warner and Arlene L. Warner,
Debtors.

Case No. 96-10373C-7G

A. Elliott Archer and Carol Archer,
Plaintiffs,

v.

Leonard L. Warner and Arlene L. Warner,
Defendants,

Adversary No. 97-2003

[Entered: Aug. 30, 1999]

JUDGMENT

In accordance with the memorandum opinion filed contemporaneously herewith, it is ORDERED, ADJUDGED AND DECREED that this action is hereby dismissed with prejudice as to Arlene L. Warner.

This 30th day of August, 1999.

/s/ William L. Stocks
WILLIAM L. STOCKS
United States Bankruptcy Judge

APPENDIX F

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:

LEONARD L. WARNER AND ARLENE L. WARNER,
Debtors.

SS# 075-30-7046

Case No. 96-10373

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Plaintiffs,

v.

LEONARD L. WARNER AND ARLENE L. WARNER,
Defendants,

Adversarial Proceeding Number 97-2003

[Entered: June 20, 1997]

CONSENT ORDER

Pursuant to the Consent of the parties and from a review of the Complaint to Determine Dischargeability of Debt and other documents files in this matter, the Court finds as follows:

1. This Adversary Proceeding is a Core Proceeding over which the Bankruptcy Court has jurisdiction pursuant to 28 U.S.C. Section 157 and 11 U.S.C. Section 523(a)(2) and (4).

2. Plaintiffs are citizens and residents of Indiana.

3. Defendants are citizens and residents of Guilford County, North Carolina. **[Page 2]**

4. On February 5, 1996, defendants filed for protection under Chapter 13 of the United States Bankruptcy Code.

5. On October 29, 1996, defendants' Chapter 13 case was converted to a case under Chapter 7 of the United States Bankruptcy Code.

6. On May 11, 1995, defendants signed a promissory note secured by deeds of trust in the amount of $100,000.00 to plaintiffs.

7. On December 4, 1995, plaintiffs filed suit against defendants in Guilford County Superior Court to enforce the Note signed by defendants.

8. The first payment of $54,500.00 on the Note was due and payable November 11, 1995, and defendants failed to pay the amount due on that date.

9. Defendants were in default under the Note for failure to pay the principal and interest due on the Note.

10. Defendants received due notice of such default and did not cure the default.

11. Plaintiffs declared the entire balance under the Note due and payable.

12. Defendants were indebted to the plaintiffs in the sum of $100,000.00 plus accrued interest at nine percent (9%) per annum, for a total debt of $104,500.00 as of November 11, 1995, and additional interest since that date.

13. The Note provided that defendants "agree to pay to the holder reasonable attorneys fees not exceeding a sum equal to fifteen percent (15%) of the outstanding balance owing on said Note, plus all other reasonable expenses incurred by the holder in exercising any of the holder's rights and remedies upon default." **[Page 3]**

14. On November 22, 1995, plaintiffs sent to defendants a letter in accordance with NCGS § 6-21.2 demanding

payment within five (5) days or, in lieu thereof, the payment of 15% attorneys fees. Defendants made no payment.

15. On January 29, 1997, plaintiffs filed a Complaint to Determine Dischargeability of Debt, which set forth the reasons that the debt to plaintiffs as represented by the Note is not dischargeable in Bankruptcy.

16. Defendant Leonard L. Warner has agreed that defendant Leonard L. Warner's debt is not dischargeable in Bankruptcy but is excepted from discharge under 11 U.S.C. Section 523(c).

17. Defendant Leonard L. Warner has authorized the entry of an Order by the United States Bankruptcy Court declaring that defendant Leonard L. Warner's debt to plaintiffs is nondischargeable.

18. The Court has jurisdiction over the subject matter and the parties to this action.

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the debt of owed by defendant Leonard L. Warner to plaintiffs as represented by the Promissory Note attached hereto as **Exhibit A** is excepted from discharge under 11 U.S.C. Section 523(c).

This 18th day of June, 1997.

/s/ William L. Stocks

Judge Presiding

[Page 4] I consent to the foregoing Consent Judgment.

/s/ Leonard L. Warner

Leonard L. Warner

Date: 5-27-97

[Exhibit A not reproduced here]

APPENDIX G

STATUTORY PROVISION

[11 U.S.C. § 523(a)]

§ 523. Exceptions to Discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--

(1) for a tax or a customs duty--

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required--

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing--

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than $1,150 for "luxury goods or services" incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than $1,150 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 60 days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act;

(3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit--

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had

notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit or property settlement agreement, but not to the extent that--

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 408(a)(3) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty--

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a

governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend, unless excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents;

(9) for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance;

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a)(2), (3), (4), (5), (6), or (7) of this title, or under section 14c(1), (2), (3), (4), (6), or (7) of such Act;

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency.

(13) for any payment of an order of restitution issued under title 18, United States Code;

(14) incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1);

(15) not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, a determination made in accordance with State or territorial law by a governmental unit unless--

(A) the debtor does not have the ability to pay such debt from income or property of the debtor not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor and, if the debtor is engaged in a business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business; or

(B) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor;

(16) for a fee or assessment that becomes due and payable after the order for relief to a membership association with respect to the debtor's interest in a dwelling unit that has condominium ownership or in a share of a cooperative housing corporation, but only if such fee or assessment is payable for a period during which--

(A) the debtor physically occupied a dwelling unit in the condominium or cooperative project; or

(B) the debtor rented the dwelling unit to a tenant and received payments from the tenant for such period,

but nothing in this paragraph shall except from discharge the debt of a debtor for a membership association fee or assessment for a period arising before entry of the order for relief in a pending or subsequent bankruptcy case;

(17) for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and

expenses assessed with respect to such filing, regardless of an assertion of poverty by the debtor under section 1915(b) or (f) of title 28, or the debtor's status as a prisoner, as defined in section 1915(h) of title 28; or

(18) owed under State law to a State or municipality that is--

(A) in the nature of support, and

(B) enforceable under part D of title IV of the Social Security Act (42 U.S.C. 601 et seq.).

* * * *

Supreme Court, U.S.
FILED
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(2)

No. 01-1418

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether a promissory note given in settlement of pending litigation can constitute a nondischargeable debt "for money, . . . or an extension, renewal, or refinancing of credit, . . . obtained by false pretenses, a false representation, or actual fraud," within the meaning of 11 U.S.C. § 523(a)(2)(A), where the parties executed a settlement agreement and general release of all claims of fraud or misrepresentation underlying the litigation and all future claims arising from the same facts, where debtor has neither admitted nor been found to have engaged in fraud in connection with the events underlying the litigation, and where the creditor has failed to allege fraud in connection with the procurement of the settlement.

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RESPONDENT'S BRIEF IN OPPOSITION

The petition for certiorari should be denied. The decision below is a careful, narrow, and correct application of § 523(a)(2) of the Bankruptcy Code. It does not conflict with decisions of the Eleventh and D.C. Circuits. Material differences of fact explain (and justify) differences in outcome in these cases. Nor does the Fourth Circuit's decision conflict with this Court's holding in *Brown v. Felsen*, 442 U.S. 127 (1979). The question whether, and under what circumstances, § 523(a)(2) renders settlement debts nondischargeable should be allowed to percolate until a true conflict emerges, if it ever does.

STATEMENT OF THE CASE

A. Statement of Facts

Petitioners sued Leonard Warner and Warner Manufacturing, Inc. in 1992, alleging that Leonard Warner had misrepresented the financial condition of Warner Manufacturing and caused Petitioners to overpay when they purchased the company. Pet. App. 2a. The State of North Carolina also pressed criminal charges (later dismissed) against Leonard Warner as a result of the transaction. *Id.* at 3a. In March 1994, Petitioners amended their complaint to add Respondent Arlene Warner as a defendant. *Id.* at 2a. On May 8, 1995, Petitioners amended their complaint to state claims for "intentional and negligent infliction of emotional distress." *Id.* Three days later, and before the Superior Court of Guilford County, North Carolina had issued any merits ruling in the case, the parties settled. *Id.*

The settlement agreement contained general and mutual releases of all pending and future claims among the parties. *Id.* at 3a. Specifically, Petitioners released "any and every right, claim, or demand which [the Petitioners] now have or might otherwise hereafter have . . . arising out of or related to the matter in Guilford County Superior Court, excepting only

obligations under a Note and deeds of trust executed contemporaneously herewith." *Id.* at 9a, 34a. In the settlement agreement, "neither party admitted liability or wrongdoing." *Id.* at 3a. In exchange for the release, Petitioners were to receive—and did receive—an immediate $200,000 cash payment, and a $100,000 promissory note payable in two installments and secured by deeds of trust on the Warners' home and a commercial building. *Id.* at 2a, 19a.

When the Warners failed to make payment as due under the promissory note, Petitioners filed suit on the note in state court. *Id.* at 3a. While the suit was pending, the Warners filed for relief under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the Middle District of North Carolina. *Id.* The Warners' Chapter 13 case was later converted to a Chapter 7 case. *Id.*

B. The Proceedings Below

Petitioners filed an adversary proceeding in the bankruptcy court to recover the amount due under the promissory note. Pet. App. at 3a. They also sought a determination that § 523(a)(2)(A) of the Bankruptcy Code—which makes nondischargeable a debt incurred as a result of "an extension . . . of credit, . . . obtained by . . . false pretenses, a false representation, or actual fraud"—prevented the promissory note debt from being discharged. *Id.* at 3a. Petitioners asserted as grounds for nondischargeability the same allegations contained in their state court action against the Warners. *Id.* at 4a. More than a year after filing the adversary proceeding, Petitioners attempted to amend their claim to allege that the settlement itself had been procured fraudulently, but the bankruptcy court rejected this request as untimely. *Id.* at 4a n.4.

Leonard Weaver consented to a judgment of liability under the promissory note, under which the obligation would be nondischargeable as to him. *Id.* at 39a-41a. Respondent Arlene Warner did not, and asserted as a defense that the

settlement agreement and two releases executed by the parties in the state court suit prevented Petitioners from relying on those allegations to support a nondischargeability claim. *Id.* at 5a-6a.

The bankruptcy court found that the settlement agreement contained "broad language [that] include[d] the release of any claims which the [Petitioners] 'might otherwise hereafter have.'" *Id.* at 35a. It held that, "[h]aving agreed to the settlement and the broad release granted to the defendants, and having received the cash payment of $200,000.00 as well as the promissory note and deeds of trust, the [Petitioners] may not now raise the dischargeability claim they now assert based upon the same allegations and claims contained in the complaint in their original actions." *Id.*

Petitioners appealed to the district court, which affirmed. The district court held that "the bankruptcy court correctly concluded that the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy." *Id.* at 21a. Although the district court acknowledged a "split of authority" (*id.*) as to the dischargeability of settlement debts in various circumstances, it found the present case "markedly similar" to the Seventh Circuit's decision in *In re West*, 22 F.3d 775 (7th Cir. 1994) and "readily distinguishable factually" from decisions of the Eleventh and D.C. Circuits in *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983) (*per curiam*) and *United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), respectively. Pet. App. at 22a. *Greenberg* did "not [involve] a waiver and release of the underlying fraud claim, while the settlement agreement in the instant case contains such a release from further liability." *Id.* *Spicer* involved "a post-conviction settlement while the present case involve[s] a pre-litigation settlement" where there has "been no determination of fraud or even a presentation of evidence on the issue at the time of settlement." *Id.*

The district court emphasized that a party may "ensure that a debt for [alleged] fraud does not become dischargeable in bankruptcy after the parties settle the claim" by "mak[ing] the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement," "mak[ing] the debtor acknowledge that any release of liability is conditional until full payment is made," and/or "subject[ing] [the settlement] to plaintiff's right to assert non-dischargeability in a bankruptcy proceeding." *Id.* at 24a. Petitioners had offered no good reason "why parties cannot bargain to account for the contingencies of liability in any given case." *Id.*

The Fourth Circuit likewise affirmed. It held that the "bargained for agreement and release" "announced the complete waiver of all pending and future related personal claims against Arlene Warner." *Id.* at 9a. Because the settlement "completely addressed and released each and every underlying state law claim," the Fourth Circuit found the case similar in all material respects to decisions of the Seventh and Ninth Circuits and held that the settlement and release "extinguished [Petitioners'] subsequent non-dischargeability claim under Section 523(a)." *Id.* at 10a. Judge Traxler dissented, arguing that the court should follow the D.C. Circuit's *Spicer* decision and conduct "the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor." *Id.* at 14a.

REASONS FOR DENYING THE WRIT

Petitioners ask this Court to find in § 523(a)(2) a duty on the bankruptcy court to act, at a creditor's request, as a sort of inquisitor general by resurrecting and adjudicating the factual allegations of settled litigation. In this case, they urge that § 523(a)(2) requires the bankruptcy court to revive and to determine the merits of a claim of fraud that was released unconditionally in exchange for a cash payment, a promissory note, and two deeds of trust. Petitioners argue that the debt embodied in the promissory note is nondischargeable even

though they failed to make any timely claim of fraud in connection with the procurement of the settlement, and there has been no admission or judicial finding of fraud on the part of the Respondent.

The Fourth Circuit's decision neither creates nor is part of any split of authority meriting this Court's attention. The Fourth Circuit's reasoning and result are entirely consonant with the two circuit court decisions that present materially identical facts—the Seventh Circuit's *West* decision and the Ninth Circuit's decision in *In re Fischer*, 116 F.3d 388 (*per curiam*), *amended*, 127 F.3d 819 (9th Cir. 1997). Indeed, Petitioners do not assert to the contrary. And the decisions of the Eleventh and D.C. Circuits that are allegedly in conflict are likewise fully consistent with the decision below in view of material factual differences among them. For similar reasons, the decision below does not conflict with this Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979). Finally, the Fourth Circuit's decision encourages settlement by empowering parties to define the terms of their settlement agreements.

I. THE DIFFERENT OUTCOMES REACHED BY THE CIRCUIT COURTS ARE FULLY RECONCILABLE BASED ON MATERIAL FACTUAL DIFFERENCES AMONG THE CASES

Petitioners suggest (Pet. at 6) that there is a "square, acknowledged, and mature split among the circuits" on the issue at hand. That issue, to state it precisely, is whether following settlement and express release of a denied and unadjudicated fraud allegation, the court handling the bankruptcy of the settlement debtor must inquire into the merits of that fraud allegation to determine whether the note should be held to be nondischargeable. Petitioners suggest that, while the Seventh and Ninth Circuits share the view taken by the Fourth Circuit here, the Eleventh and D.C. Circuits would have resolved this case differently.

Respondent says "suggest" because Petitioners ignore the factual nuances of the present case, and treat as indistinguishable all cases where "an otherwise nondischargeable debt" is the object of a settlement agreement. Pet. i (Questions Presented)

While a number of cases take note of the "conflict" urged by Petitioners, on closer examination it is clear (as the district court observed explicitly below (Pet. App. 22a-23a)) that the different outcomes reached in the circuit court decisions cited by petitioners are fully reconcilable by the materially different facts present in those cases. At most, it can be said that the authorities reflect a measure of confusion on the proper approach to the widely varying circumstances in which a claimant in bankruptcy seeks to have an agreed settlement payment treated as nondischargeable. In particular, each of the two cases on which petitioners rely for their circuit conflict is sharply distinguishable from the facts of this case. Neither suggests that it is the office of the bankruptcy court to make its own inquiry into the unresolved merits of the underlying fraud claim which petitioners have elected to categorically release as part of a good faith settlement of disputed litigation. Until there arises a square conflict among the holdings of circuit court cases, this Court should follow its usual practice of denying certiorari and allowing the issue to be clarified by further litigation.

A. The Eleventh Circuit's *Greenberg* Case, Holding That A Claim For Fraud By A Fiduciary Must Be Considered In Bankruptcy Where A Settlement Agreement Never Released The Underlying Claim, Is Fully Consistent With The Decision Below

One line of authority alleged by Petitioners to conflict with the decision below, and with the decisions of the Seventh and Ninth Circuits, concerns settlement of a dispute involving a fraud allegation that obligates the settling party to pay a sum on money, but does not include any express release or waiver

of the underlying fraud claim. That situation is presented by the Eleventh Circuit's decision in *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983) (*per curiam*). In that decision—a *per curiam* affirmance on the basis of the district court's final judgment— a suit between business partners alleging that one misappropriated corporate funds in violation of a fiduciary duty was settled prior to trial. The settlement agreement required execution of a promissory note, and the defendant, Schools, had made several periodic payments on that note. When Schools failed to make subsequent payments, plaintiff Greenberg brought a second suit on the promissory note, which was settled by stipulation of the parties, with Schools agreeing again to monthly payments in a reduced amount. Thereafter, Schools filed a petition in bankruptcy, and Greenberg filed a claim of nondischargeability under § 523(a)(4).

The trial court rejected the argument "that once the parties entered into a good faith settlement agreement, that agreement effectively extinguished the underlying action for fraud." 711 F.2d at 154. The court stated that the interpretation urged by the debtor "would allow a debtor to discharge a debt incurred by his own fraud by simply entering into a settlement agreement prior to declaring bankruptcy." *Id.* Noting with precision the "limited" nature of its ruling, as addressing (and rejecting) "only the contention that the settlement agreement serves to automatically extinguish the appellant's claim" of fraud by a fiduciary, *id.* at 156, the court concluded that the bankruptcy court should make inquiry into the factual circumstances of the underlying fraud claim.

Nowhere in any of the decisions in *Greenberg* is there any suggestion that the underlying fraud allegations had been released by the creditor as part of the settlement agreement. To the contrary, as noted by the Seventh Circuit in *West* (*see* 22 F.3d at 777), the bankruptcy court in *Greenberg* expressly stated that it "[could] not find that a novation occurred whereby the promissory note was explicitly substituted for the

cause of action." *In re Schools*, 14 B.R. 953, 955 (Bankr. S.D. Fla. 1981), *vacated on other grounds*, 21 B.R. 1011 (S.D. Fla. 1982). It appears that the creditor in *Greenberg* simply dismissed the pending litigation in exchange for the note, and that no release was granted. *Id.* at 954-55.

Absent an unconditional release, as the Seventh Circuit concluded in *West*, the claim of fraud remains open to a claimant in bankruptcy in the event that the contractual terms of the settlement are not realized. Whereas the settlement was effected in order to resolve the underlying disputed claims, the mere fact of the settlement does not, as the court in *Greenberg* stated, "automatically extinguish" the fraud claim that brought it about. In order to extinguish such a claim, the parties must enter into an agreement doing exactly that. That was done in this case; it was not done in *Greenberg*.

B. The D.C. Circuit's *Spicer* Decision, Holding That Debts Should Be Nondischargeable In Bankruptcy Where Based On Conduct Found In A Prior Proceeding To Be Fraudulent, Is Also Entirely Consistent With The Decision Below

The second line of authority alleged by Petitioners to conflict with the decision below, and the decisions of the Seventh and Ninth Circuits, involves settlement of a dispute in which the debtor has admitted, or a court already has found, that he engaged in fraudulent conduct. That situation is presented by the D.C. Circuit's decision in *United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995). Spicer pled guilty to a count of interstate transportation of money obtained by fraud, admitting that he had, on at least 81 occasions, fraudulently overstated to the Department of Housing and Urban Development down payments made by home buyers in order to help those buyers qualify for FHA-insured mortgages. *Id.* at 1154. In connection with the criminal action, the United States also had brought a civil suit against Spicer under the False Claims Act and a common-law fraud theory. *Id.* Spicer

agreed to settle the civil suit, promising to pay the government $339,000 plus interest in exchange for a deletion of a restitution order from Spicer's criminal sentence and a release of the government's civil claims against him. *Id.* Some months later, Spicer filed a Chapter 7 bankruptcy petition and sought to discharge his settlement debt. *Id.* The government argued that the debt was nondischargeable under § 523(a)(2)(A). *Id.* The D.C. Circuit held that it could not adopt a rule "under which, through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a nonfraudulent one, and thereby immunize himself from the strictures of § 523(a)(2)(A)." *Id.* at 1155.

The D.C. Circuit's concern that a debtor, whose underlying "debt to the government did indeed 'originate from' and 'derive from' his fraudulent conduct," not be allowed by the simple expedient of recasting the "legal form of that obligation . . . [to] transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A)" is simply not implicated by cases like the present one. *Id.* at 1157. To hold that a bankruptcy court should not turn a blind eye to adjudicated or admitted fraud in determining dischargeability is *not* to hold that a bankruptcy court must determine the merits of an unadjudicated or denied claim of fraud that the creditor voluntarily and unconditionally relinquished in a good faith settlement of litigation supported by valuable consideration. Nothing in *Spicer* can be said to establish such a rule. And, in this case, there has been no judicial finding of, or admission of, fraudulent conduct by Respondent. To the contrary, in the settlement and release, "neither party admitted liability or wrongdoing" (Pet. App. 3a) and the settlement clearly released all claims except for those that the parties might assert against each other arising from "obligations under a Note and deeds of trust executed contemporaneously herewith" (*id.* at 9a). Thus, following the release, the *only* basis for continuing liability against the Warners arose from the settlement agreement.

II. THE DECISION BELOW IS FULLY CONSISTENT WITH THIS COURT'S DECISION IN *BROWN V. FELSEN*

Petitioners acknowledge (Pet. 10) that there is no direct conflict between the decision below and this Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979). Instead, they contend (Pet. 11) that the decision below "clash[es]" with "principle[s] announced in *Brown*." It does not.

In *Brown*, this Court held that *res judicata* principles do not confine a bankruptcy court to reviewing only the judgment and record in a prior state court proceeding when inquiring whether the conduct underlying a debt found to exist in that prior lawsuit was fraudulent, where there had been no prior determination or stipulation that the conduct was fraudulent. 442 U.S. at 138-39. The *Brown* petitioner had alleged in a state court action that the respondent had fraudulently induced him to sign a guaranty agreement. *Id.* at 128. The state suit was "settled by a stipulation," and "[n]either the stipulation nor the resulting judgment indicated the cause of action on which respondent's liability to petitioner was based." *Id.* There was neither a release of the fraud claim nor a finding that the underlying conduct was or was not fraudulent. Upon the respondent's bankruptcy, the petitioner sought to establish that the respondent's debt was nondischargeable. *Id.* at 130. The Court held that *res judicata* principles could not prevent the bankruptcy court from conducting a "full[] . . . inquiry" into the nature of the conduct underlying the debt. *Id.* at 138.

Importantly, however, the Court did not hold that it would be proper to allow a party that has voluntarily, and expressly, released an alleged fraud claim to resurrect that claim in the bankruptcy court or to compel the bankruptcy court to pursue claims so released. In other words, while *Brown* certainly speaks to the appropriate scope of a properly instituted inquiry into the conduct underlying a debt, *Brown* does not remotely suggest that such an inquiry is required—or even

proper—where a claimant has completely relinquished his fraud claim. *See Fischer*, 116 F.3d at 391 (*Brown*'s "'res judicata' [holding] do[es] not control our case, which involves a voluntary agreement between two parties that created a novation, releasing either side from liability arising from the original contract"). Thus, there is no tension, much less any conflict, between the decision below and *Brown*.

Furthermore, *Brown* itself left open the issue whether the "narrower principle of collateral estoppel" might foreclose a bankruptcy court from inquiring into "questions actually and necessarily decided in a prior suit." 442 U.S. at 139 n.10. Settlements may occasion collateral estoppel effects if "it is clear . . . that the parties intend their agreement to have such an effect." *Arizona v. California*, 530 U.S. 392, 414 (2000). Federal courts have often found that a general release contained in a settlement of a state court action bars subsequent federal action on the same claims. *See* 18A C. Wright, *et al.*, *Federal Practice and Procedure* § 4443, at 268-70 (2002) (collecting cases). Here, Petitioners agreed to "release and forever discharge" the Warners "from any and every right, claim, or demand which [Petitioners] now have or might otherwise hereafter have [against the Warners] arising out of or relating to the matter of the litigation in Guilford County Superior Court . . . ." Pet. App. 34a-35a. On its face, therefore, the release reflects the parties' intent to preclude any future litigation of the claims settled. *Brown* may be inapposite for this separate and independent reason.

III. BY LEAVING IT TO THE PARTIES TO DEFINE THE TERMS OF THEIR SETTLEMENT AGREEMENTS, THE DECISION BELOW ENCOURAGES SETTLEMENTS

Petitioners argue that the decision below creates "an obstacle to settlement" of fraud allegations whenever a plaintiff perceives a risk of subsequent bankruptcy by a defendant, since parties with fraud claims may be reluctant to settle them if it means that the debt becomes dischargeable. Pet. at 11. This is wrong. Far from creating an obstacle to settlement, the decision below *encourages* settlement by granting parties the freedom to contractually order their respective obligations. Finality and certainty of obligations are obviously issues of paramount concern to a settling defendant, and, "as a logical matter, it simply makes no sense to conclude that mutual settlement will be encouraged by precluding negotiation over an issue that may be particularly important to one of the parties to the transaction." *United States v. Mezzanato*, 513 U.S. 196, 208 (1995). Under the reasoning of the lower courts in this case, the effect of a settlement on dischargeability will depend upon the freely negotiated agreement among the parties. As the district court stated, settling plaintiffs have ample means of protecting their interests in nondischargeability where they perceive a risk that the defendant may declare bankruptcy: They may "make the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement," "make the debtor acknowledge that any release of liability is conditional until full payment is made," and/or "subject [the settlement] to plaintiff's right to assert non-dischargeability in a bankruptcy proceeding." Pet. App. at 24a.

Petitioners also claim that the decision below provides an incentive for unscrupulous debtors to offer "an empty promise to pay the debt," thereby "threaten[ing] to open a gaping hole" in bankruptcy law's policy to help "honest but unfortunate debtors." Pet. at 12-13. But such conduct in and of itself

amounts to fraud, and a claim of a fraudulently induced settlement may well make the debt nondischargeable. This issue was not presented in this case because the Petitioners first raised it in an untimely amendment to their adversary complaint. Pet. App. at 4a n.4, 25a. Petitioners' failure to timely claim fraud in connection with the settlement is completely understandable given that the Warners paid $200,000 of the $300,000 settlement amount prior to filing for bankruptcy (Pet. App. at 2a-3a, 25a) and given that Leonard Warner, the principal target of Petitioners' original state court lawsuit, has agreed to be responsible for the remaining $100,000. Pet. App. at 39a-41a.

CONCLUSION

For these reasons, the Archers' petition for writ of certiorari should be denied.

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IN THE

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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Maryland Casualty Co. v. Cushing, 171 F.2d 257 (7th Cir. 1948).....2, 4
United States v. Spicer, 57 F.3d 1152 (D.C. Cir. 1995).....2, 3, 4, 5

STATUTES

11 U.S.C. § 523(a) .....*passim*

TREATISES

Restatement (Second) Torts § 551, cmt. a 7

IN THE

Supreme Court of the United States

No. 01-1418

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

REPLY BRIEF IN SUPPORT OF CERTIORARI

In opposing the petition, respondent argues primarily that "factual nuances" between the decisions of the Fourth, Seventh, and Ninth Circuits, on the one hand, and those of the D.C. and Eleventh Circuits, on the other, might explain the divergent results reached in the cases on the question whether an otherwise nondischargeable debt becomes dischargeable if the parties enter into a settlement agreement resolving the amount of the debt. Opp. 6. The factual differences on which respondent relies, however, did not form any part of the basis for those courts' decisions. The only explanation for the divergent results is that the courts of appeals have interpreted Section 523(a) of the Bankruptcy Code differently. At bottom, it is inescapable that a different rule of law now governs in different courts of appeals. It is for this reason that the D.C. Circuit concluded that on "our

reading of those cases, ... they cannot be reconciled," *United States v. Spicer*, 57 F.3d 1152, 1156 (D.C. Cir. 1995) (Wald, J.). Indeed, the majority and dissenting judges on the Fourth Circuit below agree that the circuits are divided on the question presented. *See* Pet. App. 8a ("there is a split among the circuits concerning this issue") (majority); *Id.* at 11a-12a (contrasting "the approach of the Ninth and Seventh Circuits" with "the competing approach adopted by the D.C. and Eleventh Circuits") (Traxler, J., dissenting). Only this Court can resolve this conflict on an important and recurring question of federal bankruptcy law. Certiorari should therefore be granted.

I. THE CONFLICTING DECISIONS CANNOT BE RECONCILED ON THEIR FACTS.

Respondent acknowledges that the decisions of the courts of appeals "reflect a measure of confusion on the proper approach" to be applied when "a claimant in bankruptcy seeks to have an agreed settlement payment treated as nondischargeable." Opp. 6. In truth, there is more than "confusion." The circuit split is square, acknowledged and mature.

A. The Circuit Split Dates to 1983, When the Eleventh Circuit's Decision in *Greenberg* Split with the Seventh Circuit's Decision in *Maryland Casualty*.

It is true that the Seventh Circuit's decision in *In re West*, 22 F.3d 775 (7th Cir. 1994), sought to reconcile the Eleventh Circuit's decision in *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983), with the Seventh Circuit's own prior decision in *Maryland Casualty Co. v. Cushing*, 171 F.2d 257 (7th Cir. 1948), along the lines suggested here by respondent. Although the Eleventh Circuit's decision in *Greenberg* plainly stated that "a debt which originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement," *Greenberg*,

711 F.2d at 156, the Seventh Circuit in *West* read that opinion more narrowly – to apply only to a set of facts that cannot be discerned from the face of the *Greenberg* decision itself. Specifically, the Seventh Circuit in *West* relied on the fact that in *Greenberg*, the state court fraud action was dismissed by stipulation, without the plaintiff expressly "releasing" the defendant from the settled claims. That fact, revealed only in the bankruptcy court opinion in *Greenberg*, is never mentioned by the Eleventh Circuit, and nothing in the Eleventh Circuit's decision suggests that the court intended its holding – that the "Bankruptcy Court should inquire into the factual circumstances behind the settlement agreement to ascertain whether or not the debt . . . was derived from the alleged fraudulent conduct" – to turn on the presence or absence of express "release" language in the settlement agreement. 711 F.2d at 156.

For this reason, the D.C. Circuit flatly rejected the Seventh Circuit's claim that the cases are reconcilable. "[W]hether or not the settlement in *Greenberg* included an express release or waiver, in our view that case stands for a broader principle: a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress in § 523(a)(2)(A), merely by altering the *form* of his debt through a settlement agreement. . . ." *Spicer*, 57 F.3d at 1156. Thus, the Eleventh Circuit's *Greenberg* decision "cannot be reconciled" with the Seventh Circuit's decisions. *Id.* Simply put, *Greenberg* and the various bankruptcy and district court opinions applying the same rule "meant what they said and said what they meant: a fraudulent debtor remains a fraudulent debtor, and debt originating in fraud remains nondischargeable even if its legal form changes under a settlement agreement." *Id.* at 1157.

B. Respondent's Effort To Reconcile the D.C. Circuit's Decision in *Spicer* with the Decisions of the Fourth, Seventh and Ninth Circuits Is Unavailing.

In addition to explaining that the Seventh and Eleventh Circuit approaches "cannot be reconciled," 57 F.3d at 1156, the D.C. Circuit's decision in *Spicer* itself squarely split with the Seventh Circuit's reasoning. Thus, even if it were possible to reconcile the Eleventh Circuit's decision in *Greenberg* with the decisions of the Seventh and Ninth Circuits, as respondent attempts to do, it cannot seriously be maintained that the D.C. Circuit's *Spicer* opinion can be harmonized with the cases it expressly rejects. In *Spicer*, the government's civil claims for fraud were "explicitly released" in exchange for the debtor's agreement to pay a specified amount. 57 F.3d at 1154. The D.C. Circuit squarely and expressly rejected the reasoning of the Seventh Circuit (also adopted by the Ninth Circuit). "We decline to follow the *Maryland Casualty* approach, however, because in our view it improperly elevates legal form over substance. We cannot agree with a rule under which, through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a nonfraudulent one, and thereby immunize himself from the strictures of § 523(a)(2)(A)." *Spicer*, 57 F.3d at 1155. By contrast, the court of appeals below did follow the reasoning set out in *Maryland Casualty* and similar cases, which it described as "the better reasoned decisions." Pet App. 8a.

Respondent accordingly does not even contend that *Spicer* can be explained away (as she would explain *Greenberg*) on the ground that the case did not involve an express release. Rather, respondent's argument is that *Spicer* is different because the debtor in that case had pled guilty to a criminal charge of fraud, whereas in this case "there has been no judicial finding of, or admission of, fraudulent conduct by Respondent." Opp. 9.

That "distinction" – which not even respondent contends formed any basis of the D.C. Circuit's decision in *Spicer* – misses the point altogether. The question presented is whether it is appropriate to look behind a settlement, and have the bankruptcy court make an independent determination whether the underlying debt is one for money obtained by means of fraud. Respondent's argument, that the bankruptcy court should be limited to considering "adjudicated or admitted fraud," is foreclosed by this Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979). In *Brown*, this Court held that in determining the dischargeability of a debt that has been reduced to a judgment, the bankruptcy court is not limited to reviewing only the pleadings and record in the prior decision. Rather, the bankruptcy court is itself "to make an accurate determination whether respondent in fact committed the deceit, fraud, and malicious conversion which petitioner alleges. . . . They are the type of question Congress intended that the bankruptcy court would resolve." *Brown*, 442 U.S. at 138. While respondent complains that the bankruptcy court should not "act, at a creditor's request, as a sort of inquisitor general," Opp. 4, this Court in *Brown* made clear that "Congress intended the fullest possible inquiry" into the question whether the underlying debt "aris[es] out of conduct" that the Bankruptcy Code specifies "should be excepted from discharge." *Brown*, 442 U.S. at 138.

In sum, any fair reading of the case law leads unavoidably to the conclusion that the different outcomes are a function of divergent constructions of Section 523(a) of the Bankruptcy Code, not "factual nuances," Opp. 6. That much is clear from the majority and dissenting opinions below, both of which expressly state that the circuit courts are divided on the question presented. "As noted by the district court, there is a split among the circuits concerning this issue. . . . We agree with the district court and the bankruptcy court that the better reasoned decisions are those of the Seventh and Ninth Circuits rather than those of the

District of Columbia and Eleventh Circuits." Pet App. 8a (majority). "There are two competing views to the main issue in this case. . . . The bankruptcy court adopted the approach of the Ninth and Seventh Circuits. . . . The competing approach [is] adopted by the D.C. and Eleventh Circuits." Pet App. 11a-12a (dissent). The circuit split identified in the petition is clear and sharp, and should be resolved by this Court.

II. THE DECISION BELOW IS INCORRECT.

A claim of fraud can take any number of forms: (1) some fraud claims will not have been liquidated to a specific amount (either by litigating to judgment or by settling) as of the date of bankruptcy filing; (2) some will have been litigated to judgment; and (3) others will have been litigated and settled. The first two categories of debt for money obtained by means of fraud are plainly excepted from the discharge. In both of these categories, the creditor bears the burden of proving to the bankruptcy court that the underlying debt is in fact for money obtained by means of fraud. The question presented by the petition is whether the third category must be treated differently, or whether the creditor should be given the same opportunity to prove that the source of the underlying debt was an act of fraud.

When a creditor has obtained a fraud judgment, it is undisputed that res judicata principles would preclude the creditor from contending that the amount of the debt is greater than is reflected in the judgment, or otherwise asserting claims against the debtor arising from the same transaction or occurrence. Despite this preclusive nature of the prior judgment, however, that creditor is of course permitted to take action to recover on that judgment (such as suing to enforce the judgment), including, according to *Brown*, proving to a bankruptcy court, with evidence beyond the four corners of the judgment and record itself, that the underlying source of the debt was an act of fraud by the

debtor, and that the debt is therefore excepted from the discharge.

The same consequences flow from a standard settlement and release. After settling a fraud action, the plaintiff cannot then continue to prosecute the existing action or initiate a different suit against the same defendant on account of the same conduct. But just as a judgment creditor can take appropriate action to recover on the judgment, including initiating a nondischargeability action in bankruptcy court, so too does a standard release (including the release at issue here) permit the plaintiff to bring action to obtain payment for the settlement amount. Consistent with *Brown*, the creditor may attempt to prove that the underlying source of the debt was an act of fraud.

In response to the argument that the rule that now controls in the Fourth, Seventh and Ninth Circuits will stand as an obstacle to settlement, respondent contends that a well-advised creditor may be able, by clever draftsmanship, to contract around the difficulties created by this rule. Even if that is correct, the construction of Section 523(a) that now controls in these courts of appeals lays a trap for the unwary.[1] As noted in the petition (and as respondent does not challenge), this trap would apply not only to creditors who

---

[1] Respondent is incorrect to suggest that a creditor who settles a fraud claim with a defendant who thereafter files for bankruptcy will necessarily be able to assert a claim of fraud in the inducement. *See* Opp. 12-13. A party who intends to file for bankruptcy has no affirmative obligation to apprise one's creditors of that intention. Accordingly, absent a special relationship or an affirmative misrepresentation, the failure to disclose that intention will not generally give rise to a claim of fraud. *See Restatement (Second) Torts* § 551, cmt. a ("Unless he is under some one of the duties of disclosure [created by a special relationship or a prior representation], one party to a business transaction is not liable to the other for harm caused by his failure to disclose to the other facts of which he knows the other is ignorant and which he further knows the other, if he knew of them, would regard as material in determining his course of action in the transaction in question.").

have been the victims of fraud, but also those who are owed other nondischargeable debt such as alimony, child support, or amounts due on account of willful and malicious injury. *See* Pet. 13-14. There is no reason to believe that this is what Congress intended. There is certainly no reason why divergent rules of law should be applied in the different courts of appeals.

CONCLUSION

For the foregoing reasons, and those set forth in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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MAY 2002

No. 01-1418 (5)

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

JOINT APPENDIX

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PETITION FOR CERTIORARI FILED MARCH 22, 2002
CERTIORARI GRANTED JUNE 24, 2002

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GENERAL DOCKET
U.S. Court of Appeals for the Fourth Circuit

Court of Appeals Docket #: 00-2525 Filed: 12/6/00
Nsuit: 3422 Bankruptcy Appeal (801)

Archer, et al v. Warner, et al

Appeal from:
Middle District of North Carolina
at Greensboro

* * * *

00-2525 Archer, et al v. Warner, et al

12/6/00	Bankruptcy case docketed. (sn)
12/8/00	Docketing notice issued. [00-2525] (sn)
12/11/00	Docketing statement filed by Appellant [3300230-1] T/S needed [Y/N]: n T/S already on file?: n/a. [00-2525] (amy)
12/12/00	Briefing order filed. [00-2525] Appellant(s) brief/joint appendix due 1/22/01 for Carol A. Archer, for A. Elliott Archer. (amy)
12/14/00	Addendum to docketing statement filed by Appellant A. Elliott Archer, Appellant Carol A. Archer. [00-2525] (sn)
12/18/00	Counsel of record form filed by Harry Glen Gordon for A. Elliott Archer, Carol A. Archer. (amy)
12/18/00	Negative disclosure statement filed by Appellant A. Elliott Archer, Appellant Carol A. Archer [00-2525] (amy)

12/20/00	Counsel of record form filed by Rayford Kennedy Adams for Appellee Arlene L. Warner. (sn)
12/20/00	Negative disclosure statement filed by Debtor Arlene L. Warner [00-2525] (sn)
12/21/00	Certification of ROA complete and retained in the District Court. [00-2525] (dad)
12/21/00	Docketing statement filed by Appellee Leonard L. Warner, Appellee Arlene L. Warner. [3305853-1]; T/S already on file: [00-2525] (sn)
1/22/01	Brief joint appendix filed by Appellant A. Elliott Archer, Appellant Carol A. Archer. Copies of brief: 8 # brf pages: 65 Sufficient[Y/N]?: Y. Copies of apx: 6 # apx pages: 156. Method of filing w/ court: HD Date of Service on parties: 1/22/01 Type of service on parties: CD Appellee brief due 2/26/01 for Arlene L. Warner. [00-2525] (aww)
2/23/01	Case tentatively calendared for oral argument Term: 5/01 Place: Richmond. SUBMISSION DEADLINE: 3/5/01. (jc)
2/26/01	Brief filed by Appellee Arlene L. Warner. Copies of brief: 8 # brf pages: 50. Sufficient[Y/N]?: y. Method of filing w/ court: HD] Date of Service on parties: 2/26/01 Type of service on parties: PM [00-2525] (wtc)
3/5/01	Motion filed by Appellant A. Elliott Archer, Appellant Carol A. Archer to submit case on briefs without oral argument [3345345-1]. [00-2525] (amy)
3/7/01	COURT ORDER filed denying motion to submit case on briefs [3345345-1] Copies to all counsel. [00-2525] (sn)

3/9/01	Reply brief filed by Appellant A. Elliott Archer, Appellant Carol A. Archer. Copies of brief: 8 # brf pages: 17. Sufficient[Y/N]?: y. Method of filing w/ court: HD Date of Service on parties: 3/9/01 Type of service on parties: PM [00-2525] (wtc)
3/30/01	Case tentatively calendared for oral argument Term: 6/01 Place: Richmond. SUBMISSION DEADLINE: 4/9/01. (jc)
3/30/01	Case tentatively calendared for oral argument Term: 6/01 Place: Richmond. SUBMISSION DEADLINE: 4/9/01. (jc)
4/9/01	Motion filed by Appellant A. Elliott Archer, Appellant Carol A. Archer to continue oral argument. [3366425-1]. [00-2525] (amy)
4/10/01	ORDER FILED granting motion to continue oral argument [3366425-1] Argument continued until the week of 9/24/01 through 9/28/01. Copies to all counsel. [00-2525] (dad)
7/13/01	Case tentatively calendared for oral argument Term: 9/01 Place: Richmond. SUBMISSION DEADLINE: 7/23/01. (jc)
7/30/01	Case calendared for oral argument. Scheduled Argument Date: 9/27/01. [00-2525] (jc)
8/23/01	Motion filed by Appellant A. Elliott Archer, Appellant Carol A. Archer to submit case on briefs without oral argument [3443112-1]. [00-2525] (mr)
8/24/01	Response/answer requested to motion to submit case on briefs [3443112-1]. Response/answer due 9/4/01 for Arlene L. Warner. [00-2525] (mr)
8/30/01	Response/answer filed [3447315-1] by Appellee Arlene L. Warner to motion to submit case on briefs [3443112-1] [00-2525] (sn)

9/6/01	COURT ORDER filed denying motion to submit case on briefs [3443112-1] Copies to all counsel. [00-2525] (sn)
9/27/01	Oral argument heard. Courtroom Deputy: aweb. [00-2525] (aweb)
3/8/02	Published, authored opinion filed. [00-2525] (sn)
3/8/02	Judgment order filed. Decision: affirmed. EOD Date: 3/8/02. [00-2525] (sn)
3/21/02	Bill of costs filed by appellee. [3557628-1] [00-2525] (sn)
4/1/02	ORDER filed awarding costs in the amount of $196.00. Copies to counsel. [00-2525] (amy)
4/1/02	Mandate issued. [00-2525] (amy)
4/2/02	Supreme Court notice that petition for certiorari was filed on 03/22/02. Spct No.: 01-1418 Spct Pty 1: A. Elliott Archer Spct Pty 2: Arlene L. Warner. [00-2525] (dhb)
4/8/02	Record on appeal returned to USDC at Greensboro. Pleadings: Vol. 1 T/S: Vol. 2 Exhibits: Vol. 3-5 [00-2525] (jsn)
5/1/02	Federal Reporter Citation: 283 F.3d 230. [00-2525] (vsl)

APPEAL CLOSED

U.S. District Court
Middle District of North Carolina (Durham)

CIVIL DOCKET FOR CASE #: 99-CV-924

* * * *

A. ELLIOTT ARCHER; CAROL A. ARCHER,
appellant

v.

ARLENE L. WARNER,
appellee

* * * *

10/19/99	1	BANKRUPTCY RECORD on appeal received and consists of the following documents: 1, 25, 49, 54, 58, 67, 69, 71, 89, *, **, 91, 92, 93, 94, 95 and 96. This is an appeal of the judgment dismissing, with prejudice, Arlene L. Warner, entered on 8/30/99, by Judge William L. Stocks. (km) [Entry date 10/22/99] [Edit date 10/25/99]
10/22/99	2	NOTICE of docketing bankruptcy record on appeal. Appellant's brief due 11/6/99 for CAROL A. ARCHER, for A. ELLIOTT ARCHER. (km)
11/3/99	3	Appellant's BRIEF by A. ELLIOTT ARCHER, CAROL A. ARCHER. Appellee's brief due 11 /18/99 for ARLENE L. WARNER (jw) [Entry date 11/04/99]
11/12/99	4	MOTION by ARLENE L. WARNER to Strike [3-1] appellant's brief by CAROL A.

ARCHER, A. ELLIOTT ARCHER (jw) [Entry date 11/15/99]

11/12/99 5 BRIEF by ARLENE L. WARNER in support of [4-1] motion to Strike [3-1] appellant's brief by CAROL A. ARCHER, A. ELLIOTT ARCHER (jw) [Entry date 11/15/99]

11/18/99 6 ADDENDUM to BANKRUPTCY APPEAL received RE: To include Issues on Appeal (See doc # 98) (lks) [Entry date 11/19/99] [Edit date 12/02/99]

11/18/99 7 Appellee's BRIEF by ARLENE L. WARNER. Appellant's reply brief due 11/28/99 for CAROL A. ARCHER, for A. ELLIOTT ARCHER (jw) [Entry date 12/02/99]

11/30/99 8 MOTION by ARLENE L. WARNER to Strike [7-1] appellant's amended designation of record on appeal and issues on appeal (jw) [Entry date 12/01/99]

11/30/99 9 BRIEF by ARLENE L. WARNER in support of [8-1] motion to Strike [7-1] appellant's amended designation of record on appeal and issues on appeal (jw) [Entry date 12/02/99]

11/30/99 10 MOTION by A. ELLIOTT ARCHER, CAROL A. ARCHER to Strike [7-1] appellee's brief by ARLENE L. WARNER (jw) [Entry date 12/02/99]

11/30/99 11 BRIEF IN OPPOSITION/RESPONSE by A. ELLIOTT ARCHER, CAROL A. ARCHER to [4-1] motion to Strike [3-1] appellant's brief by CAROL A. A. ELLIOTT ARCHER by ARLENE L. WARNER (jw) [Entry date 12/02/99]

11/30/99 11 BRIEF by A. ELLIOTT ARCHER, CAROL A. ARCHER in support of [10-1] motion to Strike [7-1] appellee's brief by ARLENE L. WARNER by CAROL A. ARCHER, A. ELLIOTT ARCHER (jw) [Entry date 12/02/99]

12/1/99 12 Appellant's REPLY BRIEF by A. ELLIOTT ARCHER, CAROL A. ARCHER. (jw) [Entry date 12/02/99]

3/6/00 13 ORDER denying [8-1] motion to Strike [7-1] appellant's amended designation of record on appeal and issues on appeal, denying [10-1] motion to Strike [7-1] appellee's brief by ARLENE L. WARNER, denying [4-1] motion to Strike [3-1] appellant's brief by CAROL A. ARCHER, A. ELLIOTT ARCHER signed by JUDGE FRANK W. BULLOCK JR. [EOD Date 3/6/00] (jw)

7/6/00 -- Argument on Bankruptcy Appeal set at 9:30 8/7/00 before JUDGE FRANK W. BULLOCK JR. in GSO 3. (dm) [Edit date 08/23/00]

7/6/00 14 NOTICE of Hearing: Argument on bankruptcy appeal - 8/7/2000 at 9:30 a.m. (before JUDGE FRANK W. BULLOCK JR.) (dm) [Edit date 07/06/00]

8/7/00 -- Argument on Bankruptcy Appeal NOT held before JUDGE FRANK W. BULLOCK JR. in GSO; Snyder court reporter. Appellant attorney not present. Hearing will be rescheduled. (dm) [Edit date 08/23/00]

8/8/00 15 NOTICE of Hearing: reset Argument on Bankruptcy Appeal for 3:00 8/29/2000 in COURTROOM #3 (GSO) (before JUDGE FRANK W. BULLOCK JR.) (dm)

8/30/00 -- Argument on Bankruptcy Appeal held before JUDGE FRANK W. BULLOCK JR. in GSO; Snyder court reporter. Court to enter findings

within next 30 days. (dm) [Entry date 09/25/00]

9/27/00 16 MEMORANDUM OPINION (signed by JUDGE FRANK W. BULLOCK JR.) re: Appellants, A. Elliott Archer and Carol A. Archer appeal an Order of the bankruptcy court entering judgment in favor of Appellee, Arlene L. Warner, on the Archers' non-dischargeability action under Section 523(a)(2) of the Bankruptcy Code. The decision of the bankruptcy court will be affirmed. An order and judgment in accordance with this memorandum opinion shall be entered contemporaneously herewith [EOD Date 9/27/00] (jw)

9/27/00 17 ORDER AND JUDGMENT signed by JUDGE FRANK W. BULLOCK JR. for the reasons set forth in the memorandum opinion filed contemporaneously herewith. Judgment of the Bankruptcy Court is AFFIRMED, and this appeal is DISMISSED. [EOD Date 9/27/00] (jw)

9/27/00 -- CASE CLOSED. Closing Code 13 (jw) [Entry date 09/28/00]

10/27/00 18 MOTION by A. ELLIOTT ARCHER, CAROL A. ARCHER to Continue time to file notice of appeal by 30 days to 11/27/2000. (dm)

10/27/00 -- Motion submission: [18-1] motion to Continue time to notice of appeal by 30 days to 11/27/2000. submitted Judge Bullock (dm)

10/27/00 19 ORDER signed by JUDGE FRANK W. BULLOCK JR. that the time for plaintiff-appellants to file a Notice of Appeal in the September 27, 2000 Order Judgment entered in this matter be extended from October 27,

2000 until Monday, November 27, 2000. Ccs to counsel [EOD Date 10/27/00] (lks)

11/27/00 20 NOTICE OF APPEAL to USCA 4th Circuit by CAROL A. ARCHER and A. ELLIOTT ARCHER Fling Fee $ 105.00 Receipt # 00065930 appealing Order and Judgment dated September 27th, 2000. (cb) [Entry date 11/28/00]

11/27/00 -- Copy of Notice of Appeal and certified copy of docket to USCA: [20-1] appeal by CAROL A. ARCHER and A. ELLIOTT ARCHER (cb) [Entry date 11/29/00] [Edit date 11/29/00]

12/12/00 21 USCA's Notice of Docketing Appeal Re: [20-1] appeal USCA Number: 00-2525; Case Manager, Sue Ellen Nagle (cb) [Entry date 12/13/00]

12/18/00 22 Clerk's Certificate transmitted to USCA that Appeal Record is Complete [20-1] appeal by CAROL A. ARCHER (cb)

U.S. Bankruptcy Court
Middle District of North Carolina (Greensboro)

* * * *

1/29/97	1	Complaint (97-2003) A. Elliott Archer vs. Leonard L. Warner NOS 426 Dischargeability 523 (Filing fee PAID). (yhp) [EOD 01/30/97] [97-2003]
1/30/97	2	1 Summons(es) issued on Arlene L. Warner, Leonard L. Warner Answer due 3/1/97 for Arlene L. Warner, for Leonard L. Warner Pre-Trial Hearing set for 9:30 4/1/97 at Courtroom #1, Greensboro; and Scheduling Memorandum due 3/28/97. (yhp) [EOD 01/30/97] [97-2003]
1/30/97	--	Pre-Trial Hearing set for 9:30 4/1/97 at Courtroom #1, Greensboro (yhp) [EOD 01/30/97] [97-2003]
2/11/97	3	Summons Served 2/7/97 on Arlene L. Warner, Leonard L. Warner. (yhp) [EOD 02/11/97] [97-2003]
3/28/97	4	Scheduling Memorandum filed by Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer. (yhp) [EOD 03/31/97] [97-2003]
4/1/97	--	Pre-Trial Hearing held (scj) [EOD 04/01/97] [97-2003]
4/4/97	5	Scheduling Order. Final Pre-Trial disclosures shall be filed on or by September 28, 1997, unless a dispositive motion is filed, in which case, the final pre-trial disclosures shall be filed within 20 days of the entry of the order ruling on the dispositive motion. (PRE MINUTE SHEET of Pre-Trial held 4/1/97, states that it is 'further ordered that the time to file

		answer is extended 30 days'. (lhg) [EOD 04/07/97] [97-2003]
4/18/97	6	Motion by the Plaintiffs, Carol A. Archer and A. Elliott Archer for Clerks Entry of Default. (yhp) [EOD 04/18/97] [97-2003]
4/18/97	7	Affidavit of Harry G. Gordon, Attorney for the Plaintiffs, Carol A. Archer and Plaintiff A. Elliott Archer. (yhp) [EOD 04/18/97] [97-2003]
4/22/97	8	Order, to Extend Time to file an Answer; Answer due: 4/30/97 for Arlene L. Warner, for Leonard L. Warner (yhp) [EOD 04/22/97] [97-2003]
5/1/97	9	Amended Motion by Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer for Clerks Entry of Default (yhp) [EOD 05/01/97] [97-2003]
5/1/97	10	Amended [7-1] Affidavit. Filed by: Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer (yhp) [EOD 05/01/97] [97-2003]
5/2/97	11	Motion by Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer for Clerks Entry of Default against the Female Defendant (ONLY). (yhp) [EOD 05/05/97] [Edit date 05/05/97] [97-2003]
5/2/97	12	Affidavit of Harry G. Gordon for Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer. (yhp) [EOD 05/05/97] [97-2003]
5/5/97	13	Answer to Complaint by Defendant, Leonard L. Warner. (yhp) [EOD 05/05/97] [97-2003]
5/8/97	14	Entry of Default as to Arlene L. Warner (yhp) [EOD 05/08/97] [97-2003]
5/9/97	--	Status Hearing set for 9:30 5/27/97 at Courtroom #1, Greensboro (yhp) [EOD 05/09/97] [Edit date 05/15/97] [97-2003]

5/9/97	15	Notice of Hearing re: [0-0] Status Hearing # Notices n/a on 5/11/97 (yhp) [EOD 05/13/97] [97-2003]
5/27/97	--	Status Hearing held (scj) [EOD 05/27/97] [97-2003]
6/18/97	16	Consent Order Granting [1-1] Complaint NOS 426 Dischargeability 523 (debt owed by Defendant, Leonard L. Warner is EXCEPTED from Discharge) (yhp) [EOD 06/20/97] [97-2003]
8/1/97	--	Status Hearing set for 9:30 8/19/97 at Courtroom #1, Greensboro (lhg) [EOD 08/01/97] [97-2003]
8/1/97	--	Hearing re: [0-0] Status Hearing set for 9:30 8/19/97 at Courtroom #1, Greensboro (lhg) [EOD 08/01/97] [97-2003]
8/1/97	17	Notice of Hearing re: [0-0] Status Hearing. # Notices 7 on 8/3/97. (lhg) [EOD 08/05/97] [97-2003]
8/14/97	18	Motion by the Plaintiffs, A. Elliott Archer and Carol A. Archer for Summary Judgment. (yhp) [EOD 08/14/97] [97-2003]
8/19/97	--	Hearing re: [0-0] Hearing Status Hearing set for 9:30 9/3/97 at Courtroom #1, Greensboro (scj) [EOD 08/19/97] [97-2003]
8/28/97	19	Affidavit of Harry G. Gordon, Attorney for Plaintiffs, Carol A. Archer, and A. Elliott Archer, in Support of Motion for Summary Judgment as to Arlene L. Warner. (lhg) [EOD 08/28/97] [97-2003]
8/29/97	20	Motion by Defendant Arlene L. Warner to Vacate and set aside [14-1] Judgment of Entry of Default by Arlene L. Warner. (lhg) [EOD 08/29/97] [97-2003]

8/29/97	--	Hearing re: [20-1] Motion to Vacate and set aside [14-1] Judgment of Entry of Default by Arlene L. Warner by Arlene L. Warner set for 9:30 9/16/97 at Courtroom #1, Greensboro (lhg) [EOD 08/29/97] [97-2003]
8/29/97	21	Notice of Hearing re: [20-1] Motion to Vacate and set aside [14-1] Judgment of Entry of Default by Arlene L. Warner by Arlene L. Warner # Notices n/a (lhg) [EOD 09/03/97] [97-2003]
9/3/97	--	Hearing held re: [0-0] Hearing. (scj) [EOD 09/03/97] [97-2003]
9/16/97	22	Affidavit of Attorney Maxine D. Kennedy. (yhp) [EOD 09/16/97] [97-2003]
9/16/97	--	Hearing held re [20-1] Motion to Vacate and set aside [14-1] Judgment of Entry of Default by Arlene L. Warner by Arlene L. Warner. (scj) [EOD 09/17/97] [97-2003]
9/16/97	23	Order Granting [20-1] Motion to Vacate and set aside [14-1] Judgment of Entry of Default by Arlene L. Warner by Arlene L. Warner. Arlene L. Warner shall have twenty (20) days from the date of this order within which to file an answer or other response to the complaint. (lhg) [EOD 09/17/97] [97-2003]
9/18/97	24	Summons Served 9/18/97 on Arlene L. Warner. (yhp) [EOD 09/18/97] [97-2003]
10/6/97	25	Answer to Complaint by Defendant Arlene L. Warner. (yhp) [EOD 10/06/97] [97-2003]
12/30/97	--	Status Hearing set for 9:30 1/27/98 at Courtroom #1, Greensboro (yhp) [EOD 12/30/97] [97-2003]
12/30/97	26	Notice of Hearing re: [0-0] Status Hearing # Notices 5 on 1/1/98 (yhp) [EOD 01/05/98] [Edit date 01/06/98] [97-2003]

1/20/98	27	Withdrawal by the Plaintiffs, Carol A. Archer and A. Elliott Archer of [18-1] Motion for Summary Judgment by Carol A. Archer, A. Elliott Archer (yhp) [EOD 01/20/98] [97-2003]
1/27/98	--	Status Hearing held g. (scj) [EOD 01/27/98] [97-2003]
2/6/98	28	Order, to continue Hearing on:([0-0] Hearing Status Hearing reset to 9:30 5/12/98 at Courtroom #1, Greensboro) (lhg) [EOD 02/06/98] [97-2003]
3/19/98	29	Motion by the Defendant, Arlene L. Warner to Extend Time to Answer Plaintiff's Carol A. Archer's First Set of Interrogatories and First Request for Production of Documents for an extension of 30 days. (lhg) [EOD 03/20/98] [97-2003]
3/19/98	30	Motion by the Defendant, Arlene L. Warner to Extend Time to Answer Plaintiff's A. Elliott Archer and Plaintiff's Carol A. Archer's First Request for Admissions for an additional thirty days. (lhg) [EOD 03/20/98] [97-2003]
3/19/98	31	Motion by the Defendant, Arlene L. Warner to Extend Time to Answer Plaintiff A. Elliott Archer's First Separate Request for Admissions for an additional thirty days. (lhg) [EOD 03/20/98] [97-2003]
3/19/98	32	Motion by the Defendant, Arlene L. Warner to Extend Time to Answer Plaintiff Carol A. Archer's First Separate Request for Admissions for an additional thirty days. (lhg) [EOD 03/20/98] [97-2003]
3/20/98	33	Order Granting [32-1] Motion to Extend Time to Answer Plaintiff Carol A. Archer's First Separate Request for Admissions for an additional thirty days by Arlene L. Warner (lhg) [EOD 03/20/98] [97-2003]

3/20/98	34	Order Granting [30-1] Motion to Extend Time to Answer Plaintiff's A. Elliott Archer and Plaintiff's Carol A. Archer's First Request for Admissions for an additional thirty days by Arlene L. Warner (lhg) [EOD 03/20/98] [97-2003]
3/20/98	35	Order Granting [29-1] Motion to Extend Time to Answer Plaintiff's Carol A. Archer's First Set of Interrogatories and First Request for Production of Documents for an extension of 30 days by Arlene L. Warner (lhg) [EOD 03/20/98] [97-2003]
3/20/98	36	Order Granting [31-1] Motion to Extend Time to Answer Plaintiff A. Elliott Archer's First Separate Request for Admissions for an additional thirty days by Arlene L. Warner (lhg) [EOD 03/20/98] [97-2003]
4/22/98	37	Response by Defendant Arlene L. Warner to Plaintiff/Carol A. Archer's First Separate Request for Admissions. (yhp) [EOD 04/23/98] [97-2003]
4/22/98	38	Response by Defendant/Arlene L. Warner to Plaintiff/A. Elliott Archer's First Separate Request for Admissions. (yhp) [EOD 04/23/98] [97-2003]
4/22/98	39	Response by Defendant/Arlene L. Warner to Plaintiff/A. Elliott Archer and Plaintiff/Carol A. Archer's First Request for Admissions. (yhp) [EOD 04/23/98] [97-2003]
5/12/98	40	Motion by the Defendant, Arlene L. Warner for Summary Judgment. (yhp) [EOD 05/12/98] [97-2003]

5/12/98 -- Status Hearing held. (scj) [EOD 05/12/98] [97-2003]

5/14/98 41 Order, to continue Hearing on:([40-1] Motion for Summary Judgment by Arlene L. Warner Hearing reset to 9:30 6/23/98 at Courtroom 1, Greensboro) (lhg) [EOD 05/15/98] [97-2003]

5/19/98 42 Motion by the Plaintiffs, Carol A. Archer and A. Elliott Archer to Compel Discovery, or in the alternative, to Deem all Requests for Admissions to be Admitted, or in the alternative, to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs, and to Award Expenses, Including Attorneys' fees (yhp) [EOD 05/19/98] [Edit date 05/19/98] [97-2003]

5/20/98 -- Hearing re: [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer set for 9:30 6/23/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer set for 9:30 6/23/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer set for 9:30 6/23/98 at Courtroom #1, Greensboro, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer set for 9:30 6/23/98 at Courtroom #1, Greensboro (yhp) [EOD 05/20/98] [97-2003]

5/20/98 43 Notice of Hearing re: [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer, [42-3] Motion to Strike all Defenses of Defendant, Arlene L.

Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer # Notices 4 on 5/22/98 (yhp) [EOD 05/27/98] [97-2003]

6/18/98 44 Response by Defendant Arlene L. Warner to [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer. (yhp) [EOD 06/19/98] [97-2003]

6/22/98 45 Objection by the Plaintiffs, Carol A. Archer A. Elliott Archer to [19-1] Affidavit by Harry G. Gordon. (yhp) [EOD 06/23/98] [97-2003]

6/23/98 -- Hearing re: [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer Cntd for 9:30 6/30/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Cntd for 9:30 6/30/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 6/30/98 at Courtroom #1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 6/30/98 at Courtroom #1, Greensboro, [40-1] Motion for Summary

Judgment by Arlene L. Warner Cntd for 9:30 6/30/98 at Courtroom #1, Greensboro (scj) [EOD 06/23/98] [97-2003]

6/23/98 46 Affidavit of Plaintiff A. Elliott Archer in Opposition to Motion for Summary Judgment by Arlene L. Warner. (yhp) [EOD 06/24/98] [97-2003]

6/23/98 47 Brief by the Plaintiffs, A. Elliott Archer and Carol A. Archer in Opposition to [40-1] Motion for Summary Judgment by Arlene L. Warner. (yhp) [EOD 06/24/98] [97-2003]

6/23/98 48 Response by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to [44-1] Response by Arlene L. Warner. (yhp) [EOD 06/24/98] [97-2003]

6/25/98 49 Motion by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to file Amended [1-1] Complaint NOS 426 Dischargeability 523. (yhp) [EOD 06/25/98] [97-2003]

6/26/98 -- Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer set for 9:30 7/21/98 at Courtroom #1, Greensboro (sad) [EOD 06/26/98] [97-2003]

6/26/98 50 Notice of Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer # Notices 7 served by BNC 6/28/98 (sad) [EOD 07/01/98] [97-2003]

6/30/98 -- Hearing re: [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/14/98 at Courtroom #1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/14/98 at Courtroom #1, Greensboro, [40-1] Motion

for Summary Judgment by Arlene L. Warner Cntd for 9:30 7/14/98 at Courtroom #1, Greensboro (scj) [EOD 07/06/98] [97-2003]

7/1/98 -- Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer set for 9:30 7/14/98 at Courtroom #1, Greensboro (yhp) [EOD 07/01/98] [97-2003]

7/1/98 51 Notice of Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer # Notices 7 on 7/3/98 (yhp) [EOD 07/07/98] [97-2003]

7/14/98 -- Hearing re: [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/21/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/21/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/21/98 at Courtroom #1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 7/21/98 at Courtroom #1, Greensboro, [40-1] Motion for Summary Judgment by Arlene L. Warner cntd for 9:30 7/21/98 at Courtroom #1, Greensboro, [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer Cntd for 9:30 7/21/98 at Courtroom #1, Greensboro (scj) [EOD 07/14/98] [97-2003]

7/21/98 -- Hearing re: [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer Cntd for 9:30 8/4/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Cntd for 9:30 8/4/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 8/4/98 at Courtroom #1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 8/4/98 at Courtroom #1, Greensboro, [40-1] Motion for Summary Judgment by Arlene L. Warner Cntd for 9:30 8/4/98 at Courtroom #1, Greensboro, [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer cntd for 9:30 8/4/98 at Courtroom #1, Greensboro (scj) [EOD 07/21/98] [97-2003]

8/4/98 -- Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer cntd for 9:30 8/11/98 at Courtroom #1, Greensboro, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer cntd for 9:30 8/11/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer cntd for 9:30 8/11/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer cntd for 9:30 8/11/98 at Courtroom #1,

Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer cntd for 9:30 8/11/98 at Courtroom #1, Greensboro (jdj) [EOD 08/05/98] [97-2003]

8/11/98 -- Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer Cntd for 9:30 9/1/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/1/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/1/98 at Courtroom #1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/1/98 at Courtroom #1, Greensboro, [40-1] Motion for Summary Judgment by Arlene L. Warner Cntd for 9:30 9/1/98 at Courtroom #1, Greensboro (scj) [EOD 08/12/98] [97-2003]

9/1/98 -- Hearing re: [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer Cntd for 9:30 9/15/98 at Courtroom #1, Greensboro, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/15/98 at Courtroom #1, Greensboro, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/15/98 at Courtroom #1, Greensboro, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/15/98 at Courtroom

		#1, Greensboro, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Cntd for 9:30 9/15/98 at Courtroom #1, Greensboro, [40-1] Motion for Summary Judgment by Arlene L. Warner cntd for 9:30 9/15/98 at Courtroom #1, Greensboro (scj) [EOD 09/01/98] [97-2003]
9/9/98	52	Amended [38-1] Response and [37-1] Response. Filed by: Defendant Arlene L. Warner to the Plaintiffs' First Separate Request for Admissions (yhp) [EOD 09/10/98] [97-2003]
9/15/98	--	Hearing held re: [40-1] Motion for Summary Judgment by Arlene L. Warner, [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer, [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer, [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer, [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer, [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer. (scj) [EOD 09/15/98] [97-2003]
9/16/98	53	Response by Defendant/Arlene L. Warner to Plaintiff/Carol Archer's First Set of Interrogatories and Request for Production of Documents. (yhp) [EOD 09/16/98] [97-2003]
10/5/98	54	Order Denying [40-1] Motion for Summary Judgment by Arlene L. Warner Denying [42-4] Motion to Award Expenses, Including Attorneys' fees by A. Elliott Archer, Carol A. Archer Denying [42-3] Motion to Strike all Defenses of Defendant, Arlene L. Warner and

		render Judgment for Plaintiffs by A. Elliott Archer, Carol A. Archer Denying [42-2] Motion to Deem all Requests for Admissions to be Admitted by A. Elliott Archer, Carol A. Archer Denying [42-1] Motion to Compel Discovery by A. Elliott Archer, Carol A. Archer Denying [49-1] Motion to file Amended [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer (yhp) [EOD 10/06/98] [97-2003]
12/10/98	--	Status Hearing set for 9:30 12/29/98 at Courtroom #1, Greensboro (yhp) [EOD 12/10/98] [97-2003]
12/10/98	55	Notice of Hearing re: [0-0] Status Hearing # Notices 7 on 12/12/98 (yhp) [EOD 12/15/98] [97-2003]
12/18/98	56	Motion by (Mercedes O. Chut)/Frank Joseph Chut for Defendant Arlene L. Warner, to Withdraw as Attorney of Record. (yhp) [EOD 12/18/98] [97-2003]
12/21/98	57	Order Granting [56-1] Motion to Withdraw as Attorney of Record by Frank Joseph Chut. Involvement of attorney Frank Joseph Chut for Arlene L. Warner, (yhp) [EOD 12/22/98] [97-2003]
12/29/98	--	Hearing re: [0-0] Hearing Status Hearing set for 9:30 2/2/99 at Courtroom #1, Greensboro (scj) [EOD 12/29/98] [97-2003]
2/2/99	--	Status Hearing held (scj) [EOD 02/02/99] [97-2003]
2/2/99	58	Order - parties shall file and serve final pretrial disclosures by 4/66/99; and to schedule Hearing on:([0-0] Trial set for 9:30 6/1/99 at Courtroom #1, Greensboro) (yhp) [EOD 02/04/99] [97-2003]

4/6/99	59	Motion by the Plaintiffs, A. Elliott Archer and Carol A. Archer to Extend the time to Comply with Order on Pre-Trial Disclosures until April 28, 1999. (yhp) [EOD 04/09/99] [97-2003]
4/9/99	60	Consent Order Granting [59-1] Motion to Extend the time to Comply with Order on Pre-Trial Disclosures until April 28, 1999 by Carol A. Archer, A. Elliott Archer (yhp) [EOD 04/09/99] [97-2003]
4/28/99	61	Plaintiffs' Pre-Trial Disclosure (yhp) [EOD 04/28/99] [97-2003]
5/12/99	62	Second Motion by the Plaintiffs, A. Elliott Archer and Carol A. Archer to Compel Discovery; for Sanctions; and to Strike Defenses. (yhp) [EOD 05/13/99] [97-2003]
5/14/99	63	Pre-trial Disclosure of Defendant, Arlene L. Warner and Objections to Plaintiffs' Pre-Trial Disclosure. (yhp) [EOD 05/19/99] [97-2003]
5/14/99	63	Pre-Trial Disclosure of Defendant, Arlene L. Warner and Objections to Plaintiffs' Pre-trial Disclosure (this is the same document as document #63, therefore, there will be no scanned image) [61-1] Document by Carol A. Archer, A. Elliott Archer. (yhp) [EOD 05/19/99] [97-2003]
5/17/99	--	Hearing re: [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer set for 9:30 5/25/99 at Courtroom #1, Greensboro, [62-2] Motion for Sanctions by Carol A. Archer, A. Elliott Archer set for 9:30 5/25/99 at Courtroom #1, Greensboro, [62-3] Motion to Strike Defenses. by Carol A. Archer, A. Elliott Archer set for 9:30 5/25/99 at Courtroom #1, Greensboro (dkp) [EOD 05/17/99] [97-2003]

5/17/99	64	Motion by the Defendant, Arlene L. Warner for Summary Judgment. (yhp) [EOD 05/21/99] [97-2003]
5/17/99	72	Notice of Hearing re: [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer, [62-2] Motion for Sanctions by Carol A. Archer, A. Elliott Archer, [62-3] Motion to Strike Defenses. by Carol A. Archer, A. Elliott Archer # Notices (sad) [EOD 06/03/99] [97-2003]
5/24/99	65	Objection by the Plaintiffs, A. Elliott Archer Carol A. Archer to [63-1] Late Filed Exhibits and Witnesses Identified by Defendant, Arlene L. Warner; and Renewed Motion to Strike Defenses. (yhp) [EOD 05/24/99] [97-2003]
5/25/99	--	Hearing re: [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer Cntd for 9:30 6/1/99 at Courtroom #1, Greensboro (scj) [EOD 05/26/99] [97-2003]
5/26/99	--	Hearing re: [65-1] Objection by Carol A. Archer, A. Elliott Archer set for 9:30 6/1/99 at Courtroom #1, Greensboro, [64-1] Motion for Summary Judgment by Arlene L. Warner set for 9:30 6/1/99 at Courtroom #1, Greensboro, [63-1] Objection by Arlene L. Warner set for 9:30 6/1/99 at Courtroom #1, Greensboro (yhp) [EOD 05/26/99] [97-2003]
5/26/99	74	Notice of Hearing re: [65-1] Objection by Carol A. Archer, A. Elliott Archer, [64-1] Motion for Summary Judgment by Arlene L. Warner, [63-1] Document by Arlene L. Warner, [63-1] Objection by Arlene L. Warner (yhp) [EOD 06/04/99] [97-2003]
5/27/99	66	Objection by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to [64-1] Second Motion

for Summary Judgment by Arlene L. Warner. (yhp) [EOD 05/28/99] [97-2003]

5/27/99 67 Renewed Motion by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to Amend [1-1] Complaint NOS 426 Dischargeability 523. (yhp) [EOD 05/28/99] [97-2003]

5/28/99 68 Plaintiffs, A. Elliott Archer and Carol A. Archer's Brief (yhp) [EOD 06/01/99] [97-2003]

5/28/99 69 Affidavit of Harry G. Gordon for Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer. (yhp) [EOD 06/01/99] [97-2003]

5/28/99 75 Bankruptcy Noticing Center Certificate of Service [74-1] Hearing Notice, [65-1] Objection by Carol A. Archer, A. Elliott Archer, [64-1] Motion for Summary Judgment by Arlene L. Warner, [63-1] Objection by Arlene L. Warner, [63-1] Document by Arlene L. Warner (yhp) [EOD 06/04/99] [97-2003]

6/1/99 70 Brief by Defendant Arlene L. Warner in Support of [64-1] Motion for Summary Judgment by Arlene L. Warner. (yhp) [EOD 06/01/99] [97-2003]

6/1/99 - Hearing held re: [62-3] Motion to Strike Defenses. by Carol A. Archer, A. Elliott Archer, [62-2] Motion for Sanctions by Carol A. Archer, A. Elliott Archer, [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer, [65-1] Objection by Carol A. Archer, A. Elliott Archer, [63-1] Objection by Arlene L. Warner, [64-1] Motion for Summary Judgment by Arlene L. Warner, [67-1] Motion to Amend [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer. (scj) [EOD 06/04/99] [97-2003]

6/2/99 71 Order Denying [62-3] Motion to Strike Defenses. by Carol A. Archer, A. Elliott Archer Denying [62-2] Motion for Sanctions by Carol A. Archer, A. Elliott Archer Denying [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer Denying [65-1] Objection by Carol A. Archer, A. Elliott Archer Denying [63-1] Objection by Arlene L. Warner Denying [64-1] Motion for Summary Judgment by Arlene L. Warner Denying [67-1] Motion to Amend [1-1] Complaint NOS 426 Dischargeability 523 by Carol A. Archer, A. Elliott Archer, to schedule Hearing on:([1-1] Complaint NOS 426 Dischargeability 523 Trial Hearing set for 9:30 6/28/99 at Courtroom #1, Greensboro) (yhp) [EOD 06/02/99] [97-2003]

6/3/99 73 Bankruptcy Noticing Center Certificate of Service [0-0] Hearing, [62-1] Motion to Compel Discovery by Carol A. Archer, A. Elliott Archer, [62-2] Motion for Sanctions by Carol A. Archer, A. Elliott Archer, [62-3] Motion to Strike Defenses. by Carol A. Archer, A. Elliott Archer (sad) [EOD 06/03/99] [97-2003]

6/11/99 76 Motion by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to continue Trial Hearing. (yhp) [EOD 06/14/99] [97-2003]

6/17/99 77 Order Granting [76-1] Motion to continue Trial Hearing by Carol A. Archer, A. Elliott Archer (cph) [EOD 06/22/99] [97-2003]

6/17/99 -- Trial set for 9:30 8/26/99 at Courtroom #1, Greensboro (cph) [EOD 06/22/99] [97-2003]

8/6/99 78 Motion by Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer to file Amended [61-1] Pre-Trial Disclosures. (yhp) [EOD 08/09/99] [97-2003]

8/13/99	79	Motion by the Defendant, Arlene L. Warner for Judgment on the Pleadings. (yhp) [EOD 08/16/99] [97-2003]
8/13/99	80	Motion by the Defendant, Arlene L. Warner in Limine (yhp) [EOD 08/16/99] [97-2003]
8/13/99	81	Brief by Defendant Arlene L. Warner in Support of [79-1] Motion for Judgment on the Pleadings. by Arlene Warner, and [80-1] Motion in Limine by Arlene L. Warner. (yhp) [EOD 08/16/99] [97-2003]
8/16/99	--	Hearing re: [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner set for 9:30 8/24/99 at Courtroom #1, Greensboro, [80-1] Motion in Limine by Arlene L. Warner set for 9:30 8/24/99 at Courtroom #1, Greensboro (yhp) [EOD 08/16/99] [97-2003]
8/16/99	82	Order Granting [78-1] Motion to file Amended [61-1] Pre-Trial Disclosures. by Carol A. Archer, A. Elliott Archer (sad) [EOD 08/16/99] [97-2003]
8/16/99	83	Motion by Defendant, Arlene L. Warner to Shorten Notice of Hearing Re: Motion for Judgment on the Pleadings and Motion in Limine, so that said Motions can be heard on 8/24/99. (yhp) [EOD 08/16/99] [97-2003]
8/16/99	86	Notice of Hearing re: [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner, [80-1] Motion in Limine by Arlene L. Warner (yhp) [EOD 08/20/99] [97-2003]
8/18/99	84	Order Granting [83-1] Motion to Shorten Notice of Hearing Re: Motion for Judgment on the Pleadings and Motion in Limine, so that said Motions can be heard on 8/24/99. by Arlene L. Warner (yhp) [EOD 08/18/99] [97-2003]

8/18/99	85	Brief and Objection by the Plaintiffs, Carol A. Archer and A. Elliott Archer in Support of [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner. (this Brief and Objection are the SAME document, therefore, there will no IMAGE) (yhp) [EOD 08/19/99] [97-2003]
8/18/99	85	Supplemental Brief and Objection by Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer to [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner. (this is the SAME document as the Brief) (yhp) [EOD 08/19/99] [97-2003]
8/18/99	87	Bankruptcy Noticing Center Certificate of Service [86-1] Hearing Notice, [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner, [80-1] Motion in Limine by Arlene L. Warner (yhp) [EOD 08/20/99] [97-2003]
8/24/99	88	Plaintiff's Trial Brief (yhp) [EOD 08/24/99] [97-2003]
8/24/99	--	Hearing held re: [80-1] Motion in Limine by Arlene L. Warner, [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner. (scj) [EOD 08/24/99] [97-2003]
8/24/99	89	Order (issues will be severed, pursuant to Rule 16(c) of the Federal Rules of Civil Procedures which is incorporated into Rule 7016 of the Federal Rules of Bankruptcy Procedure, and tried in this matter) (yhp) [EOD 08/24/99] [97-2003]
8/24/99	90	Order Denying [80-1] Motion in Limine by Arlene L. Warner Denying [79-1] Motion for Judgment on the Pleadings. by Arlene L. Warner (yhp) [EOD 08/24/99] [97-2003]
8/26/99	--	Trial Hearing held (scj) [EOD 08/30/99] [97-2003]

8/30/99	91	Judgment FOR Defendant Arlene L. Warner AGAINST Plaintiff Carol A. Archer, Plaintiff A. Elliott Archer (this action is hereby DISMISSED with Prejudice as to Defendant/Arlene L. Warner) (yhp) [EOD 08/30/99] [97-2003]
8/30/99	92	Memorandum Opinion regarding: [91-1] Judgment Order by A. Elliott Archer, Carol A. Archer, Arlene L. Warner. (yhp) [EOD 08/30/99] [97-2003]
9/9/99	93	(Appeal File) Notice of Appeal by Carol A. Archer, A. Elliott Archer Appeal Designation due: 9/19/99 re: [91-1] Judgment Order by A. Elliott Archer, Carol A. Archer, Arlene L. Warner (service was made on parties in interest by Yasmin H. Power) (yhp) [EOD 09/09/99] [97-2003]
9/20/99	94	"(Appeal File)" Designation by A. Elliott Archer, Carol A. Archer of Contents for Inclusion in Record on Appeal re: [93-1] Notice Appeal by A. Elliott Archer, Carol A. Archer; (sad) [EOD 09/20/99] [97-2003]
9/30/99	95	"(Appeal File)" Designation by Arlene L. Warner of Contents for Inclusion in Record on Appeal and Statement of the Issues on Appeal re: [93-1] Notice Appeal by A. Elliott Archer, Carol A. Archer; Transmission due: 10/30/99 (sad) [EOD 10/01/99] [97-2003]
10/18/99	96	Transcript of Hearing re: Trial held on 8/26/99 (sad) [EOD 10/18/99] [97-2003]
10/19/99	--	"(Appeal File)" Transmission of Record on Appeal to District Court re: [93-1] Notice Appeal by A. Elliott Archer, Carol A. Archer (sad) [EOD 10/19/99] [97-2003]

10/19/99	97	"(Appeal File)" Notice of Docketing Record o Appeal re: [93-1] (1:99CV00924) (sad) [EOD 10/19/99] [97-2003]
11/17/99	98	(Appeal File) Amended [94-1] Appeal Designation (Amended to add Statement of Issues only). Filed by: Plaintiff A. Elliott Archer, Plaintiff Carol A. Archer (sad) [EOD 11/18/99] [97-2003]
11/18/99	99	(Appeal File) Transmission of Addendum to Record on Appeal [93-1] Notice Appeal by A. Elliott Archer, Carol A. Archer transmitted to District Court (1:99CV000924) (sad) [EOD 11/19/99] [97-2003]
10/16/00	100	"(Appeal File)" Final Order entered on 9/27/00 by Judge Bullock Affirming the Bankruptcy Court's Judgment and Dismissing this Appeal re: [91-1] Judgment Order by A. Elliott Archer, Carol A. Archer, Arlene L. Warner (yhp) [EOD 10/16/00] [97-2003]
10/16/00	101	Memorandum Opinion regarding: [100-1] District Court Order. (yhp) [EOD 10/16/00] [97-2003]

STATE OF NORTH CAROLINA
In the General Court of Justice
Superior Court Division
Guilford County

File No. 93 CRS 2075

STATE VERSUS
Defendant LEONARD L. WARNER

Date of Offense: 3/22/92 - 5/22/92
Offense in Violation of G.S. 14-100

INDICTMENT
OBTAINING PROPERTY BY
FALSE PRETENSES

The jurors for the State upon their oath present that on or about the date of offense shown and in the county named above the defendant named above unlawfully, willfully and feloniously did knowingly and designedly with intent to cheat and defraud obtain and attempt to obtain good and lawful United States Currency in the amount of six hundred and eighty five thousand dollars ($685,000.00) from A. Elliott Archer by means of a false pretense which was calculated to deceive and did deceive.

The false pretense consisted of the following: the defendant misrepresented the financial condition of Greensboro Awning Company, Greensboro Fence Company and A&A Fence Company in negotiating for the sale of these companies to Archer.

Sold assets, received $681,585 worth of assets

Letter

Signature of Prosecutor

/s/ Howard P. Neuman

WITNESSES

☒ Ken Norris - GCSD

The witnesses marked "X" were sworn by the undersigned Foreman of the Grand Jury and, after hearing testimony, this bill was found to be:

☒ A TRUE BILL by twelve or more grand jurors, and I the undersigned Foreman of the Grand Jury, attest the concurrence of twelve or more grand jurors in this Bill of Indictment.

☐ NOT A TRUE BILL

Date: SEP 20, 1993

Signature of Jury Foreman

/s/ William P. Rynard [illegible]

STATE OF NORTH CAROLINA
GUILFORD COUNTY

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
92 CVS 7777

A. E. ARCHER COMPANIES; INC.,
A. ELLIOTT ARCHER, AND CAROL
A. ARCHER, Plaintiffs,
vs.
WARNER MANUFACTURING, INC.,
LEONARD L. WARNER, STUART
E. WARNER, ARLENE WARNER,
and WEBB LEXINGTON CORP., Defendants.

AMENDED COMPLAINT
(Jury Trial Demanded)

Plaintiffs, complaining of defendants, allege and say:

PARTIES AND INTERRELATIONSHIPS

1. Plaintiff A. E. Archer Companies, Inc. ("Archer Companies") is a North Carolina corporation having had an office and place of business in Guilford County, North Carolina.

2. Plaintiff A. Elliott Archer ("Elliott Archer") is an individual and a resident of Guilford County, North Carolina.

3. Plaintiff Carol A. Archer ("Carol Archer") is an individual and a resident of Guilford County, North Carolina.

4. Plaintiff A. Elliott Archer is the sole shareholder of Archer Companies, its chief executive officer, and a member of its Board of Directors. Elliott Archer and Carol Archer are husband and wife.

5. Defendant Warner Manufacturing, Inc. ("Warner Manufacturing") is a corporation incorporated under the laws

of the State of North Carolina on February 1, 1991, with its Registered office located at 1004 Rollingwood Drive, Greensboro, Guilford County, North Carolina. Its Registered Agent is defendant Leonard L. Warner.

6. Defendant Leonard L. Warner ("Warner") is an individual and a resident of Guilford County, North Carolina.

7. Defendant Stuart E. Warner is an individual and a resident of Guilford County, North Carolina.

8. Defendant Arlene Warner is an individual and a resident of Guilford County, North Carolina.

9. Defendant Webb Lexington Corp. is a North Carolina corporation with its Registered Office located at 1004 Rollingwood Drive, Greensboro, Guilford County, North Carolina. Its Registered Agent is defendant Leonard L. Warner.

10. Defendants Leonard Warner and Arlene Warner are husband and wife. Defendant Stuart Warner is the son of defendants Leonard Warner and Arlene Warner. Defendants Leonard Warner and Arlene Warner reside at 1004 Rollingwood Drive, Greensboro, North Carolina, the Registered Office for both defendant corporations.

11. Plaintiffs are informed and believe and therefore allege that defendant Warner Manufacturing is owned by defendants Leonard Warner and Arlene Warner as its sole shareholders, that defendant Leonard Warner and Arlene Warner served as its directors, that its officers were defendants Leonard Warner, Arlene Warner and Stuart Warner, and the Corporation was formerly named Indian Tuff-Tank, Inc. and was used in the purchase and sale of a business by that name.

12. Defendant Webb Lexington Corp. is owned one hundred percent (100%) by defendant Arlene Warner who is also Secretary of the corporation. Defendant Leonard Warner is the President and Treasurer of defendant Webb Lexington Corp. Defendant Webb Lexington Corp. has its offices in the home of defendants Leonard Warner and Arlene

Warner at 1004 Rollingwood Drive, Greensboro, North Carolina. Defendants Leonard Warner and Stuart Warner claim to be "independent contractors" who provide "consulting services" at the request of defendant Webb Lexington Corp. Defendant Webb Lexington Corp. claims to have had a contract with defendant Warner Manufacturing, Inc. whereby it provided consulting services to defendant Warner Manufacturing, Inc. and engaged defendants Leonard Warner and Stuart Warner to provide the actual consulting services.

FACTUAL ALLEGATIONS

13. During or about the early part of the month of March, 1992, plaintiff Elliott Archer caused to be published in the News and Record, a newspaper of general circulation in Guilford County, North Carolina, a classified advertisement expressing an interest in purchasing a business in the Triad area. The advertisement included the following statements: "Particular interest in profitable business which current owner is interested in selling for retirement or other personal reasons." (Emphasis added)

14. On or about March 22, 1992, in response to plaintiff Elliott Archer's advertisement, defendant Leonard Warner sent a letter to the address published in plaintiff Elliott Archer's advertisement, stating that Leonard Warner was the owner of a profitable light manufacturing company with annual sales in the range of $2,000,000.00 that had been in business for over forty years.

15. On or about April 2, 1992, plaintiff Elliott Archer met with defendant Leonard Warner and discussed the business that defendant Leonard Warner owned, the type of business, the assets and financial condition of the business, and its prior financial performance. During the course of this discussion, defendant Leonard Warner disclosed to plaintiff Elliott Archer that the company which Leonard Warner was interested in selling was Warner Manufacturing, Inc. (defendant herein), doing business as Greensboro Awning Company, Greensboro Fence Co. and A&A Fence Co. (collectively, the "Companies"). At the same meeting, defendant Leonard Warner represented to plaintiff Elliott Archer that the Companies were very profitable and offered an outstanding profit opportunity.

16. On or about April 23, 1992, defendant Leonard Warner and plaintiff Elliott Archer met for the second time. At this meeting defendant Leonard Warner delivered to Archer a copy of a document that he represented to be the income statement for the Companies as of November 30, 1991 when it was owned by the previous owner, and which purported to present, among other things, net income for the year to date in the amount of $38,376.00. A true and correct copy of the November 31, 1991 income statement as delivered by defendant Leonard Warner to plaintiff Elliott Archer is attached hereto as **Exhibit 1** and hereby expressly incorporated by reference.

17. Contrary to the representations of defendant Leonard Warner, the November 30, 1991 income statement (**Exhibit 1**) was in fact a document created by defendant Leonard Warner which did not in fact show the net income of the prior owner and was not in fact the same statement of the prior owner.

18. Contrary to the $38,376 net income shown by defendant Leonard Warner on the November 30, 1991 income statement created by defendant Leonard Warner (**Exhibit 1**), the prior owner's actual income statement showed a loss of approximately $130,000.

19. At the same April 23, 1992 meeting defendant Leonard Warner delivered to plaintiff Elliott Archer a copy of documents which purported to be financial statements for the Companies, a true and correct copy of which is attached hereto as **Exhibit 2** and hereby expressly incorporated by reference, consisting of an income statement and balance sheet, both dated as of March 31, 1992, and that contained the following misrepresentations:

a. Net income for the year to date was represented to be in the amount of $157,216.38, when in fact the Companies' had zero income.

b. Total assets net of petty cash and checking deposits were represented to be in the amount of $840,470.00, when in fact total assets were substantially less.

c. Accounts payable (trade) were represented to be in the amount of $49,453.62.

d. Notes Payable were represented to be in the amount of $20,000.00 when in fact substantial capital had been borrowed from defendant Webb Lexington and defendant Leonard Warner but the debt and interest payments/accruals were deliberately omitted to overstate income.

20. Defendant Leonard Warner also delivered to plaintiff Elliott Archer defendant Leonard Warner's evaluation of the Companies, attached hereto as **Exhibit 3** and hereby expressly incorporated by reference, which represented that the Companies were earning $360,000 per year, when in fact the Companies were not profitable and were losing money.

21. Thereafter, during or about the month of April or May 1992, defendant Leonard Warner deceived plaintiff Elliott Archer or his CPA by making the following misstatements and or misrepresentations:

a. Defendant Leonard Warner told plaintiff Elliott Archer that there were no other financial statements for the companies nor was there any further financial information for the Companies relating to periods prior to November 30, 1991.

b. Defendant Leonard Warner understated accounts payable by approximately $35,000, thus overstating the value of the assets and greatly overstating the profitably of the Companies.

c. Defendant Leonard Warner, with the knowledge and cooperation of defendants Arlene Warner and Webb Lexington Corp., failed to reveal the existence of a $100,000 loan to the prior owner, the interest charges on the loan, another loan from defendant Webb Lexington Corp. and interest charges for that loan, and a loan by defendant Leonard Warner to the business and interest on that loan.

d. Defendant Leonard Warner, with the knowledge and cooperation of defendant Stuart Warner, falsely represented that the business had in excess of $30,000 in "Inventory-Finished Goods" when in fact the goods so identified were rejects or defective manufactured items that had virtually no value.

e. Defendant Leonard Warner, with the knowledge and cooperation of defendant Stuart Warner, grossly overstated and misrepresented the value of equipment being purchased by plaintiff Elliott Archer and Archer Companies.

f. Defendant Leonard Warner deliberately and falsely understated labor costs by providing to plaintiffs' CPA, during due diligence, what said defendant represented to be total costs for labor, which labor costs in fact included only factory labor and did not include field labor.

22. During the period prior to closing, defendant Leonard Warner directed employees of defendant Warner Manufacturing not to post accounts payable in order that plaintiff Elliott Archer would not know about substantial accounts payable outstanding as of the date of closing.

23. Defendant Leonard Warner refused to allow plaintiff Elliott Archer or his CPA to confer with employees of the Companies, and said employees later, after the sale, revealed to plaintiff Elliott Archer that the business was in fact losing substantial monies, contrary to representations of defendant Leonard Warner.

24. Defendant Leonard Warner was observed by an employee of defendant Warner Manufacturing removing large volumes of financial records prior to the sale of the business. Plaintiffs are informed and believe and therefore allege that these were the records of the prior owner, which records revealed the losses the Companies had experienced.

25. Plaintiff Elliott Archer and defendant Leonard Warner structured the sale of the business as an asset sale for tax and liability reasons. Plaintiff Elliott Archer sought to acquire and did acquire an ongoing business with customer accounts, goodwill, trained employees, ongoing operations, trade names, accounts receivable and so forth. However, by structuring the sale as an "asset sale," as is customarily done in such sales, plaintiffs could recapitalize assets for tax purposes and avoid taking on warranty and other liabilities of former owners of the business. Plaintiffs also agreed to purchase certain accounts payable as well as accounts receivable. Defendant Leonard Warner agreed to operate and maintain the business in its normal and regular course between the date of contract and closing date.

26. On or about May 8, 1992, defendant Leonard Warner delivered to plaintiff Elliott Archer copies of certain documents which purported to be financial statements for the Companies, consisting of a purported Income Statement and Balance Sheet dated as of April 30, 1992, and which purported to present, among other things, the following information:

a. Net Income for the year to date in the amount of $128,049.58.

b. Total Assets net of petty cash and checking deposits in the amount of $754,334.15.

c. Accounts Payable in the amount of $62,172.00.

27. Contrary to the documents delivered by defendant Leonard Warner to plaintiff Elliott Archer on or about May 8, 1992, in fact "Net Income" was less than zero, total assets were substantially less than $754,000, and Accounts Payable

were in fact approximately $35,000 more than the reported $62,172.

28. After negotiations, defendant Warner Manufacturing, acting through defendant Leonard Warner and Stuart Warner, and plaintiff Archer Companies, acting through plaintiff Elliott Archer, executed a certain Asset Purchase Agreement (the "Agreement") dated May 22, 1992, which provided, among other things, for the purchase and sale of the Assets for a total price of $610,000.00, plus payment to defendant Leonard Warner of a consulting fee in the amount of $70,000.00 and the sum of $5,000.00 in consideration of a non-compete agreement. In executing the Agreement, plaintiff Elliott Archer relied on the above-described purported financial statements, the representations and warranties of defendants Leonard Warner, Stuart Warner and Warner Manufacturing as set forth in the Agreement and in the Certificates, and on the representations made by said defendants to plaintiff Elliott Archer prior to the execution of the Agreement.

29. While representing to plaintiff Elliott Archer and the Archer Companies that defendant Warner Manufacturing, Inc. "has operated and maintained the business in its normal and regular course, selling inventory only to customers and replenishing same on a reasonable basis to the extent depleted, and contracting and invoicing in the same manner as customarily done in the past," defendant Leonard Warner and Warner Manufacturing, Inc. in fact accelerated collections of cash and required larger cash downpayments on jobs, all cash to be retained by defendant Warner Manufacturing, while at the same time failing to show a liability on the books of the company for obligations to provide material and labor for the cash down payments collected and retained by defendants.

30. Plaintiff Elliott Archer arranged to borrow $500,000 to be used as part of the consideration for purchase of the Companies. The loan was made to plaintiff Elliott Archer's new corporation formed for the purpose of acquiring the as-

sets of the Companies. Plaintiffs Elliott Archer and Carol Archer both signed guarantees personally obligating themselves to be responsible for the full $500,000 debt.

31. The closing (the "Closing") took place on May 22, 1991. Plaintiff Archer Companies purchased, among other assets, accounts receivable totaling $141,363.76 and accounts payable of $62,172.00. A true and correct copy of the balance sheet included in the closing documents is attached hereto as **Exhibit 4**. Within approximately 30 minutes following the Closing, defendant Leonard Warner provided to plaintiff Elliott Archer an "updated" balance sheet, which balance sheet showed accounts payable of $84,852, an increase of $22,680.

32. Within days of the Closing, plaintiff Elliott Archer learned by examining the company records that in fact accounts payable on date of Closing were approximately $99,000, approximately $35,000 more than had been represented by defendant Leonard Warner. At the same time, actual accounts receivable were not significantly more than as claimed.

33. The additional, undisclosed $35,000 in accounts payable, was very alarming to plaintiffs because i) this meant that the company had $35,000 fewer assets, ii) the company required an immediate cash infusion to deal with the additional $35,000 current debt, and, iii) actual earnings and profits per sale had been grossly overstated by failing to reveal the existence of $35,000 in accounts payable.

34. Unbeknownst to defendants, the computer system sold by defendant Warner Manufacturing, Inc. to plaintiff Archer Companies with the other assets contained within it an income statement of the prior owner, a true and correct copy of which is attached hereto as **Exhibit 5** hereby expressly incorporated by reference. That income statement revealed that the income statement provided by defendant Leonard Warner to plaintiff Elliott Archer in advance of the purchase, **Exhibit 1**, was fictitious and a fraud, and that

rather than showing a profit of $38,376, the prior owner showed a loss of approximately $130,000 during its 11 months of operation in the year 1991.

35. Within the first 30 days of operation, it became apparent to plaintiffs that the business, rather than making $30,000 per month and $360,000 per year as repeatedly represented by defendant Leonard Warner, orally and in writing (**Exhibit 2**), was actually losing money each month and required an immediate infusion of capital in order to survive.

36. Within one week to ten days of Closing, plaintiff Elliott Archer confronted defendant Leonard Warner regarding the unposted accounts payable and the "found" income statement of the prior owner (**Exhibit 5**). Plaintiff Elliott Archer demanded that defendant Leonard Warner buy back the business for the price paid by plaintiff Elliott Archer or refund at least $300,000 of the price paid. Defendant Leonard Warner declined to purchase back the business or refund $300,000 of the price paid.

37. Following the Closing, plaintiff Archer Companies took possession and control of the Assets and of certain business and accounting records relating to the companies. Upon inspection of the Assets and said records, plaintiffs Elliott Archer and Archer Companies determined, subsequent to the Closing, that:

a. The values assigned to machinery and equipment in the purported financial statements furnished by defendants Leonard Warner and Stuart Warner to plaintiff Elliott Archer were greatly in excess of their actual values.

b. The values assigned to the finished goods inventory of the Companies in the aforesaid financial statements were overstated in that the actual finished goods delivered to plaintiff Archer companies consisted of goods that had been for specific jobs and that were unusable on such jobs, with said inventory having no

value beyond scrap value because it was inadequate or unsuitable for most applications.

c. Beginning during or about March 1992 and continuing through the date of Closing defendant Leonard Warner, Stuart Warner and Warner Manufacturing had discontinued the practice of posting to the accounts payable journal of the Companies a substantial number and amount of accounts payable.

d. Beginning during or about early 1992 and continuing through the date of Closing, defendants Leonard Warner and Warner Manufacturing deviated from the Companies' historical practice of deferring the billing of customers until the Companies had completed performance under their contracts with customers. Instead, defendants Leonard Warner, Stuart Warner and Warner Manufacturing caused customers to be billed for work performed prior to completion of the contracts, with defendant Warner Manufacturing retaining the monies received by the Companies on such billings and deliberately failing to reflect on company records the obligation to the customers paying in advance.

e. Defendants Leonard Warner and Warner Manufacturing had included or caused to be included in the purported financial statements furnished to plaintiffs Elliott Archer and Archer Companies, certain assets that were not the property of defendant Warner Manufacturing but were in fact assets belonging to employees.

f.. During or about early March 1992, defendants Leonard Warner and Warner Manufacturing had discontinued the practice of posting to the accounts payable journal of the Companies certain amounts for which the Companies had been billed, resulting in plaintiff Archer Companies' being forced to assume responsibility for a substantial amount of debts of the Companies which had not been disclosed to plaintiffs Elliott Archer or the Archer Companies prior to Closing.

g. The Companies had an operating loss for the year-to-date ended November 30, 1991, in the amount of approximately $130,000.00, rather than net income for the same period in the amount of $38,376.00 as reported on the fabricated income statement (**Exhibit 1**) prepared by defendants Leonard Warner and Warner Manufacturing for said period.

h. The Companies had a net loss for the first quarter of 1992 instead of the approximately $157,000.00 in earnings as represented by defendants Leonard Warner and Warner Manufacturing.

i. The Companies had a net loss for the first four months of 1992 instead of the approximately $128,000.00 in earnings as represented by defendants Leonard Warner, Stuart Warner and Warner Manufacturing.

38. Defendants, acting in concert, also overstated earnings of Warner Manufacturing by diverting expenses to defendant Webb Lexington Corp. Tax records of defendant Warner Manufacturing for tax year 1992, coupled with the sworn deposition testimony of defendant Leonard Warner, reveal that, among other expenses, defendant Warner Manufacturing paid defendant Webb Lexington Corp. $102,750 for "management fees" and another $203,750 for "consulting fees." Capital costs for the operations of Warner Manufacturing were absorbed by defendant Webb Lexington or Leonard and Arlene Warner. Defendant Leonard Warner, acting for all defendants, failed to reveal the existence of a $100,000 debt to the former owner of the business and failed to show the debt or accrued interest. All defendants deliberately withheld from plaintiffs knowledge that the foregoing expenses and costs were not accurately reflected, and the income and asset statements provided by defendant Leonard Warner to plaintiffs showed no payment or accrual of costs for interests, management fees, or consulting fees.

39. All defendants acted in concert to defraud the plaintiffs. Defendant Arlene Warner was the sole stockholder of defendant Webb Lexington Corp., the company that provided substantial undisclosed funds to purchase the Companies to be resold. She was also an officer of defendant Webb Lexington Corp. Defendant Webb Lexington Corp. hired defendants Stuart Warner and Leonard Warner as "consultants" to defendant Warner Manufacturing. As noted above, more than $300,000 of the monies received from the defrauding of the plaintiffs were paid by defendant Warner Manufacturing to defendant Webb Lexington Corp. for "management fees" and "consulting fees." Deposition testimony of defendant Stuart Warner reveals that he received approximately $70,000 as a "bonus" directly from Defendant Warner Manufacturing, notwithstanding the fact that defendant Stuart Warner claimed to be self-employed, acting as a consultant for defendant Webb Lexington Corp., paid by defendant Webb Lexington Corp., and not an employee of defendant, Warner Manufacturing.

40. Defendant Stuart Warner assisted in locating the Companies and acted as a full time employee-called -consultant for himself/Webb Lexington Corp./Warner Manufacturing. He received salary through defendant Webb Lexington Corp. Defendant Stuart Warner received approximately $70,000 as a "bonus" directly from defendant Warner Manufacturing, notwithstanding the fact that defendant Stuart Warner claimed to be self-employed, acting as a consultant for defendant Webb Lexington Corp., paid by defendant Webb Lexington Corp., and not an employee of defendant Warner Manufacturing.

41. Defendant Stuart Warner deliberately misrepresented values of assets purchased by plaintiff Archer Companies and also signed closing documents that were erroneous and fraudulent. Defendant Stuart Warner participated in the fraud additionally by claiming to have made great savings for the Companies through "purchasing activities" and by claiming to have researched and become knowledgeable about the

value of assets being sold. Defendant Stuart Warner participated in the total conspiracy and transfer of assets and fraudulent conveyance of assets and thereafter committed perjury at his deposition rather than reveal the interrelationships of all defendants.

42. All defendants conspired to purchase a distressed company for $250,000 and resell the same at an exorbitant profit--$685,000--by misrepresenting to plaintiffs that the company they had purchased was in fact making a profit of at least $30,000 per month or $360,000 per year, when in fact the business was losing money when acquired by defendants and continued to lose money during the entire six-month period it was owned by defendants or their agent, Warner Manufacturing.

43. Plaintiffs are informed and believe that defendant Leonard Warner has engaged in similar schemes to defraud business buyers in the past, and that all defendants are presently attempting a similar scheme to defraud prospective buyers in the sale of the latest business acquired in the name of defendant Arlene Warner, being Full Knit Hosiery Mills, Inc.

FIRST CLAIM FOR RELIEF
(Breach of Contract)

44. The allegations of Paragraphs 1 through 43 of this Complaint are repleaded and incorporated herein by reference as if fully set forth.

45. Plaintiff Archer Companies seek relief for breach of the representations and warranties set forth in Section 6 of the Agreement as certified by defendant Leonard Warner individually and defendants Leonard Warner and Stuart Warner as the officers of defendant Warner Manufacturing.

46. Said defendants have breached said representations and warranties, in that:

a. Said defendants failed to disclose to Archer Companies certain liabilities and obligations of the

Companies, which, under the Agreement, they were required to disclose.

b. The purported financial statements of the Companies dated April 30, 1992, identified as Exhibit A to the Agreement, were not prepared carefully in the regular way from the books and records of the Companies and are not completely true and accurate.

c. From April 30, 1992 through the Closing, Warner Manufacturing failed to operate and maintain the business of the companies in its normal and regular course.

d. From April 30, 1992, through the Closing, said defendants caused the Companies to fail to contract with and invoice customers in the same manner as customarily done in the past.

e. The representations and warranties set forth in the Agreement and in said defendants' Certificates were false and untrue and incorrect in numerous material respects.

47. As a result of the breach of the Agreement by said defendants as hereinbefore alleged, plaintiff Archer Companies has sustained damages in the amount in excess of $10,000.00 in an amount to be determined according to proof, which plaintiff Archer Companies is entitled by law to recover of and from said defendants, jointly and severally.

SECOND CLAIM FOR RELIEF
(Fraud and Misrepresentation)

48. The allegations of Paragraphs 1 through 47 of this Complaint are repleaded and incorporated herein by reference as if fully set forth.

49. Plaintiffs are informed and believe and therefore allege that defendants prepared, or caused to be prepared, the above-referenced purported financial statements of the companies and that defendants intentionally included or caused to be included therein certain false and inaccurate entries and

information and that defendants furnished such financial information and purported financial statements to Plaintiff Archer Companies and Plaintiff Elliott Archer, representing the same to be accurate and truthful.

50. Plaintiffs are informed and believe that defendants purposefully and intentionally misled and deceived plaintiffs Archer Companies and Elliott Archer by delivering to them the said false and inaccurate financial information and purported financial statements.

51. Plaintiffs are further informed and believe that defendants made the following false representations to Archer Companies and Archer about the business and financial condition of the Companies, knowing said representations to be false, misleading and inaccurate and intending that Archer Companies and Archer rely upon such representations: and that defendants defrauded and deceived Archer Companies and Archer by the following acts or omissions, to-wit:.

a. On or about April 23, 1992, Warner told Archer that there were no other financial statements of the Companies nor any further financial information for the Companies in existence for periods prior to November 30, 1991, the date on which Warner Manufacturing had acquired the Assets, when in truth and in fact there were in existence at that time numerous financial statements of the Companies and a substantial amount of financial information for the Companies for periods prior to November 30, 1991, which information and statements would have disclosed, and did disclose to plaintiffs after the Closing, that the Companies had realized minimal net income or had sustained substantial losses for one or more periods of time prior to November 30, 1991.

b. Purposely and intentionally withheld, suppressed, concealed and failed to deliver, when they had a duty to deliver to plaintiffs Archer Companies and Elliott Archer, the aforesaid financial information and financial statements for periods prior to November 30, 1991;

and in defendants' dealings and negotiations with Archer Companies and Archer on one or more occasions defendants intentionally concealed and suppressed the existence of the same.

c. On one or more occasions prior to the closing, defendants intentionally misrepresented to plaintiffs Archer Companies and Elliott Archer that the Companies had been profitable during the 11-month period immediately prior to acquisition of the Companies by defendant Warner Manufacturing and during the period defendant Warner Manufacturing owned the Companies, knowing full well that in truth and in fact the Companies had realized a minimal amount of net income or had sustained substantial losses during said periods of time.

d. Defendant Leonard Warner, acting for all defendants, provided plaintiffs Archer Companies and Elliott Archer with purported balance sheets for the Companies that contained greatly inflated and unjustified values for the Assets, knowing full well that said values as they appeared thereon were false and substantially overstated, while representing to plaintiffs Archer Companies and Elliott Archer that said values were the actual or approximate value of the Assets, and while defendants knew that in truth and in fact the values of the Assets were substantially less than the values as stated therein, and with defendants having the purpose and intent to mislead and deceive Defendants Archer Companies and Elliott Archer and to induce plaintiff Archer Companies, as purchaser of the Assets, to pay a higher price than the Assets were actually worth.

e. Defendants knew or had a reasonable basis to believe that plaintiffs Archer Companies and Elliott Archer would rely, and had the right to rely, on the aforesaid false and misleading representations, statements and documents which defendants provided to plaintiff Archer Companies and Elliott Archer, and knew

or had a reasonable basis for believing, that such reliance would result, or would be likely to result, in substantial damage and detriment to plaintiffs Archer Companies and Elliott Archer, yet defendants nevertheless made and continued to make such false and misleading statements and representations and to furnish such incorrect, false and misleading documents as hereinbefore alleged.

f. Defendants embarked upon a course of action and a scheme and artifice to defraud Archer Companies and Archer by realizing a substantial, exorbitant and "quick" profit on the resale of the Assets between the period of time beginning on or about December 10, 1991, when defendant Warner Manufacturing purchased the Assets for a total purchase price of $250,000.00, and May 22, 1992, the date of the Closing, at which time Archer Companies paid defendant Warner Manufacturing the sum of $600,000.00 as the balance of the purchase price of the assets (the further sum of $10,000.00 having previously been paid as an earnest money deposit for the purchase of the Assets), and in addition paid defendant Leonard Warner a consulting fee of $70,000.00 and the further sum of $5,000.00 for certain restrictive covenants against competition.

g. Defendants intentionally concealed and failed to disclose, when they had a duty to disclose, to plaintiffs Archer Companies and Elliott Archer the fact that beginning during or about March 1992, and continuing through the date of Closing, Warner and Warner Manufacturing had discontinued the practice of posting to the accounts payable journal of the Companies a substantial number and amount of accounts payable.

h. Defendants intentionally concealed, suppressed and failed to disclose, when they had a duty to disclose, to plaintiffs Archer Companies and Elliott Archer the fact that beginning, during or about early 1992 and continuing through the date of Closing, defendants Warner

and Warner Manufacturing had deviated from the Companies' historical practice of deferring the billing of customers until the Companies had completed performance under their contracts with customers and further failed to disclose, when they had a duty to disclose, to plaintiffs Archer Companies and Elliott Archer that defendants Warner and Warner Manufacturing had caused certain customers of the Companies to be billed for work performed prior to completion of the Companies' contracts with such customers; and intentionally concealed and failed to disclose, when they had a duty to disclose, to plaintiffs Archer Companies and Elliott Archer that the Companies and defendant Warner Manufacturing had received and retained, prior to completion of such contracts, a substantial amount of such customer payments, knowing full well that Archer Companies had agreed to be responsible for labor and materials necessary to complete the performance of such contracts, and would not receive corresponding payment from customers of the Companies under the contracts.

i. Defendants induced plaintiffs Archer Companies and Elliott Archer, as an officer of Archer Companies, to execute the Agreement and further induced plaintiff Archer Companies to purchase the Assets and the "stream of income" of the Companies at a price which defendants knew full well was greatly in excess of the actual or approximate value of the Assets and the Companies' "stream of income."

j. Defendants, acting in concert, in like fashion induced plaintiffs Elliott Archer and Carol Archer to guarantee the $500,000 loan to plaintiff Archer Companies.

k. Defendants, acting in concert, failed to reveal the existence of Webb Lexington Corp., the capital investment of defendants Webb Lexington Corp and Leonard Warner, the "Consulting Agreements" involving

defendant Webb Lexington Corp., and the $300,000 in payments by defendant Warner Manufacturing to defendant Webb Lexington Corp.

52. Plaintiff's reasonably relied on the misrepresentations of the defendants and plaintiffs reasonably relied on the failure of defendants to disclose when defendants had a duty to disclose, all to plaintiffs' detriment and damage.

53. By reason of the foregoing unlawful acts, omissions and misrepresentations, defendants have purposefully and intentionally deceived and defrauded plaintiffs, to the damage and detriment of plaintiffs who are entitled to recover of and from defendants, jointly and severally, damages based upon and resulting from the fraud, misrepresentations and deception perpetrated by defendants as hereinbefore alleged, in the amount of at least $10,000.00, according to proof.

54. The actions of defendants in misleading, defrauding and deceiving plaintiffs, all as hereinbefore alleged, were willful, wanton and intentional, were calculated to damage and harm plaintiffs and were made and taken with utter disregard of the rights and interests of plaintiffs.

55. By reason of the matters and things alleged in this Complaint, plaintiffs are entitled to recover of and from defendants punitive damages in amounts according to proof.

THIRD CLAIM FOR RELIEF
(Conspiracy)

56. Plaintiffs repeat and reallege paragraphs 1 through 55.

57. On information and belief, defendants conspired with each other to defraud plaintiffs as herein alleged, and the defendants conspired to do unlawful acts or to do lawful acts in an unlawful manner. The conduct of the defendants as alleged in this Complaint constitute acts in furtherance of the conspiracy.

58. Defendants are liable to plaintiffs for conspiracy to commit a tort (fraud), for conspiracy to take plaintiffs' prop-

erty by false pretenses in violation of G.S. § 14-100, and for acts in furtherance of the conspiracy for an amount in excess of $10,000.00 for all expenses, losses, and damages plaintiffs have suffered as a result of defendants' acts in furtherance of the conspiracy, and the acts of defendants having been deliberate, intentional, willful, wanton, malicious and wrongful, defendants are liable for punitive damages.

FOURTH CLAIM FOR RELIEF
(Pierce Corporate Veil)

59. Plaintiffs repeat and reallege paragraphs 1 through 58.

60. Plaintiffs are informed and believe and therefore allege that defendants Leonard Warner and Arlene Warner operated defendants Warner Manufacturing and Webb-Lexington Corp. as an instrumentality or alter ego of themselves as sole shareholders, as controlled, family corporations with all family shareholders, all family officers, and all family directors. Defendant Leonard Warner for himself and Arlene Warner, and with defendant Arlene Warner controlling all entities with "hired consultants", exercised such complete domination of the policy and business practices of defendants Warner Manufacturing and Webb Lexington Corp. that defendants Warner Manufacturing and Webb Lexington Corp. had no mind, will or existence of their own separate and apart from the individual defendants.

61. Plaintiff is informed and believes and therefore alleges that defendants Leonard Warner and Arlene Warner inadequately capitalized the controlled corporations, said defendants siphoned corporate funds to themselves and to defendant Stuart Warner and transferred funds from defendant Warner Manufacturing to defendant Webb Lexington Corp., defendants did not maintain adequate corporate and financial records, and the controlled corporations are insolvent.

62. Plaintiff is informed and believes and therefore alleges that defendants Leonard Warner and Arlene Warner controlled both defendant corporations in such a way as to

commit a fraud or wrong, the control and breach of duty proximately caused the injury complained of, and the corporate veil should be disregarded to hold accountable said defendants who engaged in the acts complained of as to do otherwise would result in injustice and be fundamentally unfair.

FIFTH CLAIM FOR RELIEF
(Fraudulent Conveyance)

63. Plaintiffs repeat and reallege paragraphs 1 through 62 herein.

64. Defendant Warner Manufacturing, Inc., at the time of transfer of monies to defendants Webb Lexington Corp., Arlene Warner and Stuart Warner for less than full and fair consideration, did not retain sufficient assets to pay its debts then existing.

65. On or about May 22, 1992 and continuing through the dates that over $300,000 were paid out by defendant Warner Manufacturing, for "consulting fees" and "management fees," the defendants with intent to injure the plaintiffs, conspired together to transfer for less than full and fair value the chief asset of defendant Warner Manufacturing, to wit cash from the sale of the Companies, without either providing for or retaining sufficient assets to pay said debts. In May, 1992 through December 31, 1992, a valid debt existed between defendant Warner Manufacturing and plaintiff Archer Companies as said plaintiff was entitled to a full refund of monies paid.

66. At the time of the transfer of the said cash, all defendants were aware of the existence of valid claims of the plaintiffs and the demands for a refund of all monies paid.

67. All defendants engaged in acts that constitute a badge of fraud in that a) they engaged in a fraudulent conveyance, b) they failed to disclose to plaintiffs or their representatives the existence of the family corporation, being defendant Webb Lexington Corp., and the "consulting arrangements." They transferred all cash out of defendant Warner Manufacturing to a family company and family

members in an attempt to put the cash beyond the reach of plaintiffs.

68. Said conspiracy is in violation of North Carolina General Statutes Section 39-15.

69. Plaintiffs have been damaged in an amount in excess of $10,000.00 because of defendant Warner Manufacturing's fraudulent conveyance and conspiracy to defraud creditors and violation of GS § 39-15, and plaintiffs are also entitled to exemplary damages in an amount in excess of $10,000.00.

SIXTH CLAIM FOR RELIEF
(Unfair or Deceptive Acts and Practices)

70. The allegations of Paragraphs 1 through 69 of this Complaint are repleaded and incorporated herein by reference as if fully set forth.

71. Defendants, individually or acting on behalf of all defendants, unlawfully engaged in unfair and deceptive trade acts and practices affecting commerce in violation of N.C.G.S. §75-1.1: in making the foregoing false, misleading and deceptive representations to plaintiffs Archer Companies and Elliott Archer about the Companies and their business; in purposely furnishing to plaintiffs Archer Companies and Elliott Archer false and misleading purported financial statements and information about the Companies; in intentionally concealing, suppressing and failing to deliver or make known to plaintiffs Archer Companies and Elliott Archer the existence of material and relevant financial information about the Companies concerning its operations and performance prior to November 30, 1991; in intentionally operating the business of the companies in a manner that substantially deviated from historical practices for performance and billing under the Companies' contracts; in inducing plaintiff Archer Companies to pay for certain assets owned by employees of the Companies, which assets Warner Manufacturing did not own and had no right to purport to convey; in causing and inducing plaintiffs Archer Companies and

Elliott Archer to believe that the false, misleading and untrue financial information and financial statements were true and accurate, when defendants knew full well that in truth and in fact said financial information and statements were false, misleading and inaccurate; in intending to mislead and deceive plaintiffs Archer Companies and Elliott Archer about the financial condition and performance of the Companies and the value of the Assets; and in other manners and ways.

72. The conduct of the defendants--including but not limited to the willful and deliberate breach of contract, the conspiracy, the legal fraud and misrepresentation, the taking by false pretenses in violation of G.S. § 14-100, the fraudulent conveyances, and the inequitable assertion of the defendants' power and positions--exhibit bad faith, offend established public policy, were unethical, oppressive and substantially injurious to plaintiffs, constitute intentional wrongdoings and deception and substantial aggravating circumstances, and constitute unfair or deceptive acts and practices in or affecting commerce as are declared unlawful under North Carolina General Statutes Section 75-1.1.

73. Plaintiffs are entities who were and continue to be injured by reason of the acts and things done by the defendants in violation of the NCGS Chapter 75 and are thus entitled to a cause of action for injury done, and pursuant to NCGS Section 75-16, treble damages of the amount fixed by the verdict and pursuant to NCGS Section 75-16.1, reasonable attorney fees.

74. Defendants are liable to plaintiffs for unfair and deceptive acts for all expenses, losses, damages, and injury plaintiffs have suffered because of their acts and to treble damages.

75. Plaintiffs are entitled to attorney fees as a) defendants violated NCGS Chapter 75, b) defendants willfully engaged in the act or practice complained of, c) there was an unwarranted refusal by defendants to fully resolve the matter which constitutes the basis of the Chapter 75 complaint, and

d) plaintiffs suffered actual injury as a result of the Chapter 75 violation.

SEVENTH CLAIM FOR RELIEF
(Constructive Trust)

76. Plaintiffs repeat and reallege paragraphs 1 through 75 herein.

77. Defendants have been unjustly enriched in that they have acquired title to money and other property through fraud, breach of duty, wrongdoings, and circumstances making it inequitable for defendants to retain title to the monies of plaintiff and the capital stock and assets of Full Knit Hosiery Mills, Inc. and other assets acquired by any defendant with plaintiffs' monies.

Plaintiffs are entitled to have a court of equity impose a constructive trust for the benefit of plaintiffs on the monies, capital stock and assets of Full Knit Hosiery Mills, Inc., and all other assets purchased with plaintiffs' monies, all directly or indirectly being the property of plaintiffs.

WHEREFORE, plaintiffs respectfully pray of the Court:

1. That defendants be required to render a full and complete accounting of all funds transferred out of defendant Warner Manufacturing since the date of closing, May 22, 1992.

2. That a constructive trust be impressed upon a) all monies received by any defendant from any plaintiff, directly or indirectly, and b) all properties, stock, or other assets purchased with any such funds, including the assets and stock of Full Knit Hosiery Mills, Inc.

3. That the Court disregard the corporate entity as to defendants Warner Manufacturing and Webb Lexington Corp., as appropriate to avoid injustice, and declare defendants Leonard Warner and Arlene Warner personally liable for the contract and other obligations of defendant Warner Manufacturing.

4. That defendants, jointly and severally, be required to pay plaintiffs a sum in excess of $10,000.00 for compensatory damages.

5. That defendants, jointly and severally, be required to pay plaintiffs a sum in excess of $10,000.00 as punitive damages.

6. That defendants pay plaintiffs treble damages pursuant to NCGS Chapter 75.

7. That defendants pay plaintiffs fair and reasonable attorneys' fees pursuant to NCGS Section 75-16.1.

8. That defendants be required to account to plaintiffs for all moneys and other assets transferred from defendant Webb Lexington Corp. to any defendant since May 22, 1992.

9. That the Court enjoin all defendants from conveying away any additional property without order of the Court.

10. That the Court issue an order pursuant to GS 39-15 setting aside the fraudulent conveyances of the assets of defendant Warner Manufacturing, being all monies received from any plaintiff.

11. That defendants pay interest at the highest rate allowed by law.

12. That defendants pay plaintiff such additional amounts as may be proven at trial, plus interest, additional reasonable attorneys' fees, and other costs in connection with this action.

13. That the Court grant plaintiff such other relief as the Court shall deem just and proper.

PLAINTIFFS DEMAND TRIAL BY JURY ON ALL ISSUES SO TRIABLE.

This the 2nd day of March, 1994.

/s/ Harry G. Gordon
Harry G. Gordon

Attorney for Plaintiffs

/s/ Robert L. Johnston
Robert L. Johnston
Attorney for Plaintiffs

OF COUNSEL:

GORDON & JOHNSTON
Independence Center, Suite 302
400 W. Market Street
Greensboro, NC 27401
Telephone: (919) 275-9910

STATE OF NORTH CAROLINA
COUNTY OF GUILFORD

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
92 CVS 7777

A. E. ARCHER COMPANIES, INC.,
A. ELLIOTT ARCHER and
CAROL A. ARCHER, Plaintiffs,

vs.

WARNER MANUFACTURING, INC.,
LEONARD L. WARNER,
STUART E. WARNER,
ARLENE WARNER, and
WEBB LEXINGTON CORP., Defendants.

SETTLEMENT AGREEMENT

This will confirm the terms of a definitive settlement agreement reached on May 11, 1995, by and among the parties to this litigation.

The total settlement amount to be paid to A. Elliott Archer and Carol A. Archer by Leonard L. Warner or one or more of the other defendants as compensation for emotional distress/personal injury type damages is $300,000.00 less legal and accounting expenses paid on their behalf by Leonard L. Warner or one or more of the other defendants.

Payment shall be made as follows:

1. $200,000.00 in certified or bank check will be paid to A. Elliot Archer and Carol A. Archer by Thursday, 5:00 p.m., May 11, 1995, less any amount paid in legal and accounting fees on their behalf.

2. $100,000.00 promissory note providing for payments of $50,000.00 each, plus accrued interest at nine percent (9.00%), payable the first six months after May 11, 1995, and the second $50,000.00 plus interest payment due one year after May 11, 1995. The promissory note shall be secured by a second lien on a $500,000.00 property owned by one or more of the defendants, and a third lien on the home of defendants Leonard Warner and Arlene Warner. The promissory note and mortgage documents shall be signed by Leonard Warner and Arlene Warner. The parties agree to use N.C. Bar Association Form No. 4, copyright 1976, revised 1985, and N.C. Deed of Trust Form published by the N.C. Bar Association, Form No. 5, copyright 1976, revised September, 1985.

The willingness of A. Elliott Archer and Carol A. Archer to resolve this case for the agreed amount in significant part results from the fact that compensation for emotional distress and personal injury type claims are non-taxable, plus numerous defenses asserted by the defendants to the claims of A.E. Archer Companies, Inc., including claims that the corporation sustained no economic loss. Defendants agree to take no action to cause adverse income taxes to plaintiffs.

All parties agree to cooperate in any reasonable way with plaintiffs in signing release agreements which reflect the nontaxable nature of the compensation, to the extent permitted by tax laws.

Plaintiffs agree to inform the District Attorney that they have been compensated for their loss and they would not oppose any resolution of the pending criminal matter in a fashion satisfactory to the State. The parties expressly agree that this Settlement Agreement does not reflect in any way that plaintiffs have used the criminal process to force a civil settlement.

All parties agree to make no disclosure of the terms of this Settlement Agreement. All parties to the litigation agree to execute releases to any and all claims any party may have or may have had against the other in any way arising out of this litigation, except as to amounts set forth in this Settlement Agreement.

The parties intend by signing this Settlement Agreement to be legally bound to complete the settlement, dismissal of the litigation, and payment of the above amounts, and to finalize and execute all usual and customary additional documents, if any, necessary to effectuate a full and complete settlement of this litigation. To the extent any further negotiation is required, the parties expressly agree to negotiate in good faith and use best efforts to consummate the settlement, and all parties agree not to assert the defense of agreement-to-agree or similar defenses to avoid or attempt to avoid the legal obligation to consummate the settlement of this litigation on the above terms and the dismissal with prejudice of the litigation.

The parties agree that the attached General Release, Mutual Release, and Promissory Note are satisfactory in form. It is contemplated that the $300,000.00 figure will be divided between payment to the individual plaintiffs and legal and accounting fees, with the total being $300,000.00. The parties further agree that this Settlement Agreement shall be null and void if the pending criminal action is not dismissed by the State of North Carolina. In addition, the plaintiffs expressly agree to take no further action to cause criminal action to be re-instituted against any defendant in the future. The $200,000.00 in certified or bank check will be paid in escrow to Harry G. Gordon, to his trust account. The Note and deeds of trust shall be delivered to Harry G. Gordon to be held by him in escrow until the terms and conditions of the settlement have been met. Mr. Gordon expressly agrees not to disburse any amount whatsoever from the escrow account or release the Note or the deeds of trust therefrom to

any person unless and until the criminal action has been dismissed and the terms and conditions of the settlement have been met.

It [sic] witness whereof, the parties hereto, intending to be legally bound, have caused this Settlement Agreement to be executed by their duly authorized representatives on the dates set forth below. This Agreement shall be binding upon the signing parties even if not signed by Stuart E. Warner or his agent.

/s/ A. Elliott Archer
A. Elliott Archer

/s/ Carol A. Archer
Carol A. Archer

A.E. ARCHER COMPANIES, INC.

BY: /s/ A. Elliott Archer
A. Elliott Archer, President

Leonard L. Warner
Arlene Warner
Webb Lexington Corp.

BY: /s/ R. Horace Swiggett, Jr.
R. Horace Swiggett, Jr., Esq.
Attorney acting for all above parties

Stuart E. Warner

BY: /s/ Daniel H. Monroe
(by Horace Swiggett)
Daniel H. Monroe, Esq.
Attorney for Stuart E. Warner

ADDENDUM TO SETTLEMENT AGREEMENT

The parties agree that the attached General Release and Mutual Release are satisfactory in form. It is contemplated that the $300,000.00 figure will be divided between payment to the individual plaintiffs and legal and accounting fees, with the total being $300,000.00. The parties further agree that this Settlement Agreement shall be null and void if the pending criminal action is not dismissed by the State of North Carolina. The $200,000.00 in certified or bank check will be paid in escrow to Harry G. Gordon, to his trust account. The Note and deeds of trust shall be delivered to Harry G. Gordon to be held by him in escrow until the terms and conditions of the settlement have been met. Mr. Gordon expressly agrees not to disburse any amount whatsoever from the escrow account or release the Note or the deeds of trust therefrom to any person unless and until the criminal action has been dismissed with prejudice and the terms and conditions of the settlement have been met.

A. Elliott Archer
Carol A. Archer
A.E. ARCHER COMPANIES, INC.

BY: /s/ Harry G. Gordon May 9, 1995
Harry G. Gordon, Esq.
Attorney for all Plaintiffs

Leonard L. Warner
Arlene Warner
Webb Lexington Corp.

BY: /s/ R. Horace Swiggett, Jr.
R. Horace Swiggett, Jr., Esq.
Attorney acting for all above parties

Stuart E. Warner

BY: /s/ Daniel H. Monroe
(by Horace Swiggett)
Daniel H. Monroe, Esq.
Attorney for Stuart E. Warner

STATE OF NORTH CAROLINA
COUNTY OF GUILFORD

GENERAL RELEASE

THIS RELEASE, made and entered into by and between A. Elliott Archer and Carol A. Archer, parties of the first part, and Warner Manufacturing, Inc., Leonard L. Warner, Arlene Warner, Stuart E. Warner and Webb Lexington Corp., parties of the second part;

WITNESSETH

FOR AND IN CONSIDERATION of the sum of $300,000.00, the parties of the first part do hereby release and forever discharge the parties of the second part from any and every right, claim, or demand which the parties of the first part now have or might otherwise hereafter have against the parties of the second part from the beginning of the world to the date of this release arising out of or relating to the matter of the litigation in Guilford County Superior Court, File No. 92-CVS-7777, (the "Lawsuit"), excepting only obligations under a Note and deeds of trust executed contemporaneously herewith.

The payment of the sum of $300,000.00 by one or more defendants as herein described is paid to Carol A. Archer and A. Elliott Archer in settlement of their personal claims for emotional distress/personal-injury-type damages they claim to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction of emotional distress, and negligent infliction of emotional distress. The parties further acknowledge that all sums set forth above constitute payment for claims of damages resulting from personal injuries or sickness or mental and emotional distress in a case involving prosecution of a legal suit or action based upon tort or tort-type rights within the meaning of §104 (A) (2) of the Internal Revenue Code of 1954 as amended.

No party admits any liability or wrongdoing whatsoever in signing this agreement. It is understood and agreed that

the settlement in this matter is the compromise of disputed claims, and that payment is not to be construed as an admission of liability on the part of any party to this agreement, all such liability being expressly denied.

NONDISCLOSURE/CONFIDENTIALITY: The parties, their attorneys and CPA's agree that the settlement terms are confidential and that they will not disclose the amount, terms, or conditions of the settlement to any other person, firm, or corporation, or news media. The parties, their attorneys and CPA's agree that they will limit their comments concerning the settlement of this matter to a statement that the matter has been resolved to the satisfaction of the parties and the terms and conditions of the settlement are confidential and may not be disclosed.

Each party does hereby represent to all other parties that he, she or it is satisfied with the legal services that he, she or it has received in this matter, and that this release has been signed willingly and voluntarily and with full knowledge of all facts and other matters relevant to the Lawsuit.

IN WITNESS WHEREOF, the parties of the first part and the parties of the second part have hereunto set their hands and seals the dates set forth below.

PARTIES OF THE FIRST PART:

/s/ A. Elliott Archer (SEAL) 5/11/95
A. Elliott Archer Date

/s/ Carol A. Archer (SEAL) 5/11/95
Carol A. Archer Date

PARTIES OF THE SECOND PART:

Warner Manufacturing, Inc.

By: /s/ Leonard L. Warner (SEAL) 5/11/95
Date

Webb Lexington Corp.

By: /s/ Leonard L. Warner (SEAL) 5/11/95
Date

/s/ Leonard L. Warner (SEAL) 5/11/95
Leonard L. Warner Date

/s/ Arlene Warner (SEAL) 5/11/95
Arlene Warner Date

/s/ Stuart E. Warner (SEAL) 5/11/95
Stuart E. Warner Date

STATE OF NORTH CAROLINA
COUNTY OF GUILFORD

MUTUAL RELEASE

THIS MUTUAL RELEASE, made and entered into by and between A. Elliott Archer and Carol A. Archer, A.E. Archer Companies, Inc., their agents and representatives, all hereinafter Parties of the First Part, and Warner Manufacturing, Inc., Leonard L. Warner, Arlene Warner, Stuart E. Warner and Webb Lexington Corp., their agents and representatives, all hereinafter Parties of the Second Part;

WITNESSETH:

FOR AND IN CONSIDERATION of mutual promises to release each other from any and all claims in any way arising out of or relating to the matter of Guilford County Superior Court litigation entitled A.E. ARCHER COMPANIES INC. A. ELLIOTT ARCHER AND CAROL A. ARCHER v. WARNER MANUFACTURING, INC., LEONARD L. WARNER, STUART E. WARNER, ARLENE WARNER and WEBB LEXINGTON CORP.; File No. 92-CVS-7777, (the "Lawsuit") and other good and valuable consideration, receipt of which is hereby acknowledged, 1) the Parties of the First Part do hereby release and forever discharge the Parties of the Second Part and all other persons and entities whomsoever, from any and every right, claim, or demand which the Parties of the First Part have against the Parties of the Second Part from the beginning of the world to the date of this release, particularly including, but not limited to, all claims, demands and causes of action in the Lawsuit and all claims, demands and causes of action that could have been asserted therein, excepting only obligations under a Promissory Note and Mortgages executed simultaneously or near simultaneously herewith, and 2) the Parties of the Second Part do hereby release and forever discharge the Parties of the First Part and all other persons and entities whomsoever, from any and every right, claim, or demand that the Parties of

the Second Part have against the Parties of the First Part from the beginning of the world to the date of this release, particularly including, but not limited to, all claims, demands and causes of action in the Lawsuit and all claims, demands and causes of action that could have been asserted therein. The Lawsuit and all claims therein will be dismissed with prejudice by the plaintiffs forthwith.

NONDISCLOSURE/CONFIDENTIALITY: The parties, their attorneys and CPA's agree that the settlement terms are confidential and that they will not disclose the amount, terms, or conditions of the settlement to any other person, firm, or corporation, or news media. The parties, their attorneys and CPA's agree that they will limit their comments concerning the settlement of this matter to a statement that the matter has been resolved to the satisfaction of the parties and the terms and conditions of the settlement are confidential and may not be disclosed.

No party admits any liability or wrongdoing whatsoever in signing this agreement. It is understood and agreed that the settlement in this matter is the compromise of disputed claims, and that payment is not to be construed as an admission of liability on the part of any party to this agreement, all such liability being expressly denied.

An additional release document is being executed simultaneously herewith, wherein Carol Archer and A. Elliott Archer release all of their claims. Said additional release shall be considered as cumulative to all of the matters and things set forth herein, and said additional release shall in no way subtract from or in any way diminish this release. The terms of the two releases are contractual in nature and not mere recitals.

Each party does hereby represent to all the other parties that he, she or it is satisfied with the legal services that he, she or it has received in this matter, and that this release has been signed willingly and voluntarily and with full knowledge of all facts and other matters relevant to the Lawsuit.

IN WITNESS WHEREOF, the Parties of the First Part and the Parties of the Second Part have hereunto set their hands and seals the dates set forth below.

PARTIES OF THE FIRST PART:

/s/ A. Elliott Archer (SEAL) 5/11/95
A. Elliott Archer Date

/s/ Carol A. Archer (SEAL) 5/11/95
Carol A. Archer Date

A.E. Archer Companies, Inc.

By: /s/ A. Elliott Archer (SEAL) 5/11/95
President

PARTIES OF THE SECOND PART:

Warner Manufacturing, Inc.

By: /s/ Leonard L. Warner (SEAL) 5/11/95
Date

Webb Lexington Corp.

By: /s/ Leonard L. Warner (SEAL) 5/11/95
Date

/s/ Leonard L. Warner (SEAL) 5/11/95
Leonard L. Warner Date

/s/ Arlene Warner (SEAL) 5/11/95
Arlene Warner Date

/s/ Stuart E. Warner (SEAL) 5/11/95
Stuart E. Warner Date

PROMISSORY NOTE
(Bar Form No.4)

Greensboro, N.C.
$100,000.00
May 11, 1995

FOR VALUE RECEIVED the undersigned, jointly and severally, promise to pay to A. Elliott Archer and Carol A. Archer, or order, the principal sum of ONE HUNDRED THOUSAND AND NO/100 DOLLARS ($100,000.00), with interest from date hereof, at the rate of nine percent (9.0%) per annum on the unpaid balance until paid or until default, both principal and interest payable in lawful money of the United States of America, at the office of Harry G. Gordon, Attorney, 400 W. Market Street, Suite 302, Greensboro, NC 27401, or at such place as the legal holder hereof may designate in writing. It is understood and agreed that additional amounts may be advanced by the holder hereof as provided in the instruments, if any, securing this Note and such advances will be added to the principal of this Note and will accrue interest at the above specified rate of interest from the date of advance until paid. The principal and interest shall be due and payable as follows:

> One (1) payment of $54,500.00, principal and interest, due November 11, 1995, and one (1) payment of $52,250.00, principal and interest, due May 11, 1996.

If not sooner paid, the entire remaining indebtedness shall be due and payable on May 11, 1996.

If payable in installments, each such installment shall, unless otherwise provided, be applied first to payment of interest then accrued and due on the unpaid principal balance, with the remainder applied to the unpaid principal.

Unless otherwise provided, this Note may be prepaid in full or in part at any time without penalty or premium. Par-

tial prepayments shall be applied to installments due in reverse order of their maturity.

In the event of (a) default in payment of any installment of principal or interest hereof as the same becomes due and such default is not cured within ten (10) days from the due date, or (b) default under the terms of any instrument securing this Note and such default is not cured within fifteen (15) days after written notice to maker, then in either such event the holder may without further notice, declare the remainder of the principal sum, together with all interest accrued thereon and, the prepayment premium, if any, at once due and payable. Failure to exercise this option shall not constitute a wavier of the right to exercise the same at any other time. The unpaid principal of this Note and any part thereof, accrued interest and all other sums due under this Note and the Deed of Trust, if any, shall bear interest at the rate of nine percent (9.0%) per annum after default until paid.

All parties to this Note, including maker and any sureties, endorsers, or guarantors hereby waive protest, presentment, notice of dishonor, and notice of acceleration of maturity and agree to continue to remain bound for the payment of principal, interest and all other sums due under this Note and the Deed of Trust notwithstanding any change or changes by way of release, surrender, exchange, modification or substitution of any security for this Note or by way of any extension or extensions of time for the payment of prineipal and interest; and all such parties waive all and every kind of notice of such change or changes and agree that the same may be made without notice or consent of any of them.

Upon default the holder of this Note may employ an attorney to enforce the holder's rights and remedies and the maker, principal, surety, guarantor and endorsers of this Note hereby agree to pay to the holder reasonable attorneys fees not exceeding a sum equal to fifteen percent (15%) of the outstanding balance owing on said Note, plus all other reasonable expenses incurred by the holder in exercising any of

the holder's rights and remedies upon default. The rights and remedies of the holder as provided in this Note and any instrument securing this Note shall be cumulative and may be pursued singly, successively, or together against the property described in the Deed of Trust or any other funds, property or security held by the holder for payment or security, in the sole discretion of the holder. The failure to exercise any such right or remedy shall not be a waiver or release of such rights or remedies or the right to exercise any of them at another time.

This Note is to be governed and construed in accordance with the laws of the State of North Carolina.

This Note is given for monies owed. This Note is secured by a (second) deed of trust on a property owned by Hosiery Industries, Inc. and a (third) deed of trust on property owned by Leonard Warner and Arlene Warner, with Deeds of Trust being executed contemporaneously with the signing of this Promissory Note.

IN TESTIMONY WHEREOF, each corporate maker has caused this instrument to be executed in its corporate name by its _____ President, attested by its Secretary, and its corporate seal to be hereto affixed, all by order of its Board of Directors first duly given, the day and year first above written.

HOSIERY INDUSTRIES, INC.

By: /s/ Leonard L. Warner
_____President

ATTEST: /s/ Arlene Warner
_____Secretary (Corporate Seal)

IN TESTIMONY WHEREOF, each individual maker has hereunto set his hand and adopted as his seal the word

"SEAL" appearing beside his name, the day year first above written.

/s/ Leonard L. Warner (SEAL)
Leonard L. Warner

/s/ Arlene Warner (SEAL)
Arlene Warner

STATE OF NORTH CAROLINA
Guilford County

In the General Court of Justice
Superior Court Division

File No. 93 CRS 20705

STATE VERSUS
Defendant: LEONARD L. WARNER

Offense: Obtaining Property by False Pretenses
G.S. 15A-302(e), -931, -932, -1009

Date of Offense: 3/22/92 - 5/22/92
Offense in Violation of G.S. 14-100

[FILED: May 12, 1995]

DISMISSAL NOTICE OF REINSTATEMENT

( ) DISMISSAL

The undersigned District Attorney enters a dismissal to the above charge(s) and assigns the following reasons:

( ) 1. No crime is charged.

( ) 2. There is insufficient evidence to warrant prosecution for the following reasons:

( ) 3. Defendant has agreed to plead guilty to the following charges:

in exchange for a dismissal of the following charges:

(x) 4. Other: (specify) ISSUES HAVE BEEN RESOLVED TO VICTIM'S SATISFACTION IN CIVIL SUIT.

A jury has not been impaneled nor has evidence been introduced. (If a jury has been impaneled, or if evidence has been introduced, modify this sentence accordingly.)

( ) DISMISSAL WITH LEAVE

The undersigned District Attorney enters a dismissal with leave to the above charge(s) and assigns the following reasons:

( ) 1. The defendant failed to appear for a criminal proceeding at which his attendance was required and the District Attorney believes that the defendant can not readily be found.

( ) 2. The defendant has been indicted and cannot readily be found to be served with an Order For Arrest.

( ) 3. The defendant has entered into a deferred prosecution agreement with the District Attorney in accordance with the provisions of Article 82 of G.S. Chapter 15A.

( ) 4. The defendant has been found by a court to be incapable of proceeding pursuant to Article 56 of G.S. Chapter 15A.

( ) 5. Other: (specify)

NOTE: This form must be completed and signed by the District Attorney when the dismissal occurs out of court. The better practice is for the District Attorney to complete and sign the form when the charges are orally dismissed in open court.

Date: 5-9-95 Signature of District Attorney
/s/ Howard P. Neuman [Illegible]

( ) REINSTATEMENT

( ) 1. This case having previously been dismissed with leave because the defendant failed to appear in court as required, is now reinstated for trial.

( ) 2. The defendant has failed to comply with the deferred prosecution agreement.

Date: Signature of District Attorney

_____

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION

STATE OF NORTH CAROLINA
GUILFORD COUNTY
92 CVS 7777

[FILED MAY 15, 1995]

A.E. ARCHER COMPANIES, INC., A. ELLIOTT ARCHER, AND CAROL A. ARCHER, Plaintiffs,

vs.

WARNER MANUFACTURING, INC., LEONARD L. WARNER, STUART E. WARNER, ARLENE WARNER, and WEBB LEXINGTON CORP., Defendants.

PLAINTIFFS' NOTICE OF VOLUNTARY DISMISSAL

Plaintiffs A.E. Archer Companies, Inc., A. Elliott Archer, and Carol A. Archer, by and through their undersigned counsel, hereby gives notice pursuant to Rule 41(a) of the North Carolina Rules of Civil Procedure that they dismisses the above-styled action, with prejudice.

This the 12th day of May, 1995.

/s/ Harry G. Gordon
Harry G. Gordon,
Counsel for Plaintiffs

OF COUNSEL:

GORDON & JOHNSTON
Independence Center, Suite 302
400 W. Market Street
Greensboro, NC 27401
TELEPHONE: (910) 275-9910
FACSIMILE: (910) 275-8797

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE: DEBTOR

LEONARD L. WARNER
1004 ROLLINGWOOD DRIVE
GREENSBORO NC 27410-0000
SSN: 075-30-7046
AKA:
DBA:

ARLENE L. WARNER
1004 ROLLINGWOOD DRIVE
GREENSBORO NC 27410-0000
SSN: 449-64-9614
AKA:
DBA:

CASE NO. 96-10373
[RECEIVED: (by Chapter13 Standing Trustee) Mar 9, 1996]

CHAPTER 13 PROOF OF CLAIM

1. This Proof of Claim is made for the claimant named below who states that: (Check appropriate box)

☐ He is the claimant	☐ The claimant is a corporation, and the undersigned is an authorized officer of such corporation	☐ The claimant is a partnership and the undersigned is a member thereof.	☒ The undersigned is the agent or attorney for the claimant

2. Unpaid principal or unpaid amount of judgment. This amount should not contain unmatured interest. Where applicable, interest will be computed by the Trustee's office as provided in the plan. (CLAIMS INCLUDING UNMATURED INTEREST (i.e., GROSS BALANCE) MAY BE DEEMED TO BE FRAUDULENT). (2) $ 104,500.00

3. Additional charges allowable. Itemize: Interest 11/11/95 to 2/5/96 $2,216.22. 15% Attorney Fees to date suit filed (12/4/95; $15,768.91) (3) $ 17,980.13

4. Less any credits. Include insurance and warranty cost rebate. Itemize: (4) $ 0.00

5. Total claim amount. The pay off (net balance) on account as of date petition filed. (5) $ 122,480.13

6. If claimant has judgment state amount of judgment and date

7. Classification and basis of claim: (Check appropriate block)

☐ Unsecured - Attach copy of statement or note.

☒ Secured - Monthly contract payment is _____ and interest rate is _____. Claimant estimates value of collateral to be _____. [ILLEGIBLE]

Attach copy of the security instrument, promissory note and proof of perfection. Holders of real estate mortgages and other long term debt which extends beyond the term of the

plan should attach a statement reflecting the arrearage and other charges due as of the date petition filed.
☐ Other - attach documentation.

SEE ATTACHED DOCUMENTATION

8. The claimant signing below hereby asserts a claim against the debtor in the amount above. The claimant states that there are no set gifts or counterclaims which the debtor may have: that the undersigned is authorized to file this Proof of Claim; and, that this claim does not contain un-matured interest.

9. Disbursements will be mailed to the address below unless a different address is provided in this area.

To receive an acknowledgment of the filing of your claim, file an original and two copies of the claim form enclosing a stamped, self-addressed envelope.

In order to ensure a feasible plan is proposed, creditors are encouraged o file this Proof of Claim prior to the Meeting of Creditors.

ADDRESSEE

GORDON, HARRY G. ESQ.
SUITE 302, 400 W. MARKET STREET
GREENSBORO, NC 77401-0000

FILE ORIGINAL AND ONE COPY OF CLAIM WITH ATTACHMENTS WITH TRUSTEE:

TRUSTEE:

ANITA JO KINLAW TROXLER
201 S--EL- STREET [ILLEGIBLE]
P.O. BOX ----- [ILLEGIBLE]
GREENSBORO NC 27402-1720

Your Account Number: ELLIOT ARCHER
Claim # [ILLEGIBLE]

PENALTY FOR PRESENTING FRAUDULENT CLAIM: FINE UP TO $500,000 OR IMPRISONMENT FOR UP TO 5 YEARS OR BOTH. TITLE 18, U.S.C. §152 & §3623

PRINT NAME Harry G. Gordon
SIGNATURE /s/ Harry G. Gordon
TITLE: Attorney Date: 3/7/96

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:

LEONARD L. WARNER AND
ARLENE L. WARNER,

SS# 075-30-7046

Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373
Adversarial Proceeding
Number: 97-2003

[FILED: Jan. 29, 1997]

COMPLAINT TO DETERMINE
DISCHARGEABILITY OF DEBT

1. This is an adversary proceeding to determine dischargeability of a debt pursuant to 11 U.S.C. Section 523(a) of the Bankruptcy Code.

2. On February 5, 1996, defendants filed for protection under Chapter 13 of the United States Bankruptcy Code.

3. On October 29, 1996, defendants' Chapter 13 case was converted to a case under Chapter 7 of the Bankruptcy Code.

4. Plaintiffs are individuals and residents of Indiana.

5. Defendants are individuals and residents of Guilford County, North Carolina.

6. On or about May 11, 1995, the defendants signed a Promissory Note secured by deeds of trust for $100,000.00 to plaintiffs. The loan arrangement permitted the defendants to make one (1) payment of $54,500.00 due November 11, 1995, and one (1) payment of $52,250.00 due May 11, 1996, defendants have made no payments.

7. Defendants agreed on May 11, 1995 to pay plaintiffs the sum of $100,000.00, being the original amount of the Promissory Note, and defendants agreed to pledge property owned by Hosiery Industries, Inc. and property owned by defendants as collateral to secure the Promissory Note and deeds of trust.

8. Prior to and since the filing of bankruptcy, the defendants have failed to pay any of the required payments or to make any arrangement to pay the outstanding indebtedness, and defendants have declined voluntarily to surrender the collateral to plaintiffs.

9. Plaintiffs are the holders of a secured claim against the defendants as evidenced by the Promissory Note and Deeds of Trust signed by defendants. The indebtedness is in the original principal amount of $100,000.00, plus interest at 9.0% from May 11, 1995.

10. The Note provides that defendants "agree to pay to the holder reasonable attorneys fees not exceeding a sum equal to fifteen percent (15%) of the outstanding balance owing on said Note, plus all other reasonable expenses incurred by the holder in exercising any of the holder's rights and remedies upon default." On November 22, 1995 plaintiffs made a five-day demand in accordance with G.S. §6-21.2, but defendants made no payment.

11. On December 4, 1995, plaintiffs filed a suit in Guilford County Superior Court, file #95 Cvs 10310, to collect the outstanding balance of principal and interest plus fifteen percent (15%) attorney fees as allowed by North Carolina law.

12. Plaintiffs had a fully perfected security interest in accordance with the Deeds of Trust on the properties of Hosiery Industries, Inc. and defendants' home at 1004 Rollingwood Drive, Greensboro, North Carolina.

13. Plaintiffs expressly incorporate by reference the terms and conditions of the Amended Complaint plaintiffs filed against defendants in Guilford County Superior Court, case no. 92 Cvs 7777, setting forth causes of action for, among other matters, fraud, misrepresentation, conspiracy to defraud, conspiracy to take plaintiffs' property by false pretenses in violation of criminal statute G.S. §14-100, and, in general, for deliberate, intentional, willful, wanton, malicious, and wrongful acts of defendants in an elaborate scheme by which defendants took hundreds of thousands of dollars from plaintiffs by false pretenses.

14. The $100,000.00 Promissory Note and Deeds of Trust arose out of a settlement of Superior Court action 92 Cvs 7777 in which plaintiffs asserted claims against defendants for fraudulent conduct and conspiracy to take plaintiffs' property by false pretenses in violation of criminal law, G.S. §14-100.

15. Plaintiffs hereby expressly incorporate by reference the terms and conditions of a confidential Settlement Agreement, Mutual Release, and Non-Disclosure/Confidentiality Agreement signed by the plaintiffs and defendants on or about May 11, 1995.

16. In consideration for defendants signing the Promissory Note and Deed of Trust referenced above, plaintiffs consented to the dismissal of an indictment against defendant Leonard L. Warner for obtaining property by false pretenses in violation of criminal statute G.S. §14-100.

17. Attached hereto and hereby expressly incorporated by reference as Exhibit A is a true and correct copy of the dismissal of felony charges against defendant Leonard L. Warner for obtaining property by false pretenses in 93 CrS 22725, with the offense shown as "obtaining property by false pretenses" and the reason for dismissal stated to be "Issues Have Been Resolved to Victims' Satisfaction in Civil Suit."

18. Defendants' debt to plaintiffs should be excepted from discharge and declared nondischargeable under Bankruptcy Code Section 523(a) as defendants obtained money and property by false pretenses, false representations, and actual fraud and through the use of materially false written financial statements with intent to deceive and upon which plaintiffs reasonably relied. As further reason to except the debt from discharge, defendants' conduct was in gross violation of criminal law, G.S. §14-100, which declares it a felony to take property by false pretenses, and the state of North Carolina dismissed felony charges based on express representations that defendants would compensate plaintiffs for losses plaintiffs sustained by virtue of the taking by false pretenses.

WHEREFORE, the plaintiffs pray:

1. That the debt owed to plaintiffs by defendants be determined to be excepted from discharge under 11 U.S.C. Section 523(a);

2. That plaintiffs have and recover of defendants the principal sum of $100,000.00 plus interest at the rate of 9.0% per annum from May 5, 1996.

3. That plaintiffs have and recover of defendants reasonable attorneys' fees of 15% of the outstanding balance, to which they are lawfully entitled by North Carolina General Statutes §6-21.2.

4. That plaintiffs have and recover of defendants the costs of this action to be taxed by the Clerk.

5. That plaintiffs have and recover of and from defendants such other and further relief as to the Court may seem just and proper.

This the 29th day of January, 1997.

/s/ Harry G. Gordon
Harry G. Gordon,
Attorney for Plaintiffs
State Bar No. 5628

OF COUNSEL:

GORDON & JOHNSTON
Independence Center, Suite 302
400 W. Market Street
Greensboro, NC 27401
Telephone: (910) 275-9910

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:
LEONARD L. WARNER and
ARLENE L. WARNER,
Debtors.

A. ELLIOT ARCHER and
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER and
ARLENE L. WARNER, Defendants.

Case No. 96-10373
ADVERSARIAL PROCEEDING
Number: 97-2003

[FILED Oct. 6, 1997]

DEBTOR'S ANSWER TO COMPLAINT TO DETERMINE DISCHARGEABILITY

Now comes the female Debtor, Arlene L. Warner, through her undersigned counsel, and responds to the Complaint to Determine Dischargeability of Debt in the above captioned Adversary Proceeding and responds to Complaint as follows:

FIRST DEFENSE

As a first defense the Female Debtor responds to the numbered paragraphs of the Complaint as follows:

1. The allegations contained in Paragraph 1 of the Complaint are admitted.

2. The allegations contained in Paragraph 2 of the Complaint are admitted.

3. The allegations contained in paragraph 3 of the Complaint are admitted.

4. The Female Debtor does not have sufficient information so as to form a belief as to the truth of the allegations contained in Paragraph 4 of the Complaint and such allegations are therefore denied.

5. The allegations contained in Paragraph 5 of the Complaint are admitted.

6. The allegations contained in Paragraph 6 of the Complaint are admitted.

7. The allegations contained in Paragraph 7 of the Complaint are admitted.

8. The allegations contained in paragraph 8 of the Complaint are admitted.

9. The Female Debtor admits that the principal amount of the Note was $100,000.00. The remaining allegations of Paragraph 9 call for a legal conclusion as to the secured status of the Plaintiff's claim against the Debtors and is therefore denied.

10. The Note speaks for itself and is the best evidence of its terms. The Female Debtor does not have sufficient information so as to form a belief as to the truth of the allegations contained in Paragraph 10 of the Complaint and such allegations are hereby denied.

11. The allegations contained in Paragraph 11 of the Complaint are admitted.

12. The Female Debtor does not have sufficient information so as to form a belief as to the truth of the allegations contained in Paragraph 12 of the Complaint and such allegations are therefore denied. Furthermore, Paragraph 12 of the Complaint calls for a legal conclusion and therefore does not require a response.

13. To the extent that the allegations contained in Paragraph 13 require a response such allegations are denied. The Plaintiff's Complaint in 92 CVS 7777 speaks for itself and is the best evidence on its own terms. A copy of such complaint is not attached to the Plaintiff's Complaint in this action.

14. The Female Debtor admits that the $100,000.00 Promissory Note and Deed of Trust arose out of the settlement of the civil action captioned 92 CVS 7777. The Female Debtor denies that such settlement constituted an admission of liability on her part as to any of the allegations contained in the Complaint in 92 CVS 7777.

15. To the extent that the allegations contained in Paragraph 15 require a response, such allegations are denied. The documents incorporated by reference speak for themselves and are the best evidence of their terms.

16. The Female Debtor does not have information sufficient to form a belief as to the truth of the allegations contained in Paragraph 16 of the Complaint. The Female Debtor notes that she was not indicted for obtaining property by false pretenses.

17. The documents attached to the Complaint speak for themselves and are the best evidence of their terms. To the extent that the allegations contained in Paragraph 17 require a response, such allegations are denied.

18. The allegations contained in Paragraph 18 of the Complaint are denied. The Female Defendant affirmatively pleads that she has at no time been indicted for any violation of the North Carolina Criminal Code.

SECOND DEFENSE

As a further defense and as an affirmative defense, the Female Debtor Pleads that the $100,000.00 debt to the Plaintiffs arising **form** the settlement of Guilford County Civil Action 92 CVS 777 which is in issue in this Adversary Proceeding did not arise from any fraud, false representations, use of materially false statements in writing or actual fraud in

any manner so as to be a non-dischargeable debt under 11 U.S.C. Section 523(a)(2).

THIRD DEFENSE

As a further defense and as an affirmative defense, the Female Debtor pleads that she has at no time admitted liability as to any of the claims in the Complaint in Guilford County Civil Action, 92 CVS 777 and that judgment was not entered against her in that action. The settlement of Guilford County Civil Action 92 CVS 7777 was a settlement of disputed claims and did not constitute an admission of liability. The Female Debtor denies that she was, or is, in any way liable to the Plaintiffs for any fraud or obtaining of property through false pretenses.

WHEREFORE, the Female Debtor respectfully requests that the Court:

1. Determine the Female Debtor's liability to the Plaintiffs to be dischargeable;

2. Deny the Plaintiff's prayer for relief and dismiss this Adversary Proceeding with prejudice;

3. Tax the Plaintiff with the costs of this action; and

4. Grant such other and further relief as in necessary in the interests of justice.

This is the 6th day of October, 1997.

/s/ Frank J. Chut, Jr.
Frank J. Chut, Jr.
State Bar No. 17696

OF COUNSEL:
Chut & Chut, PA
Attorneys for Arlene Warner
PO Box 20164
Greensboro, NC 27420
(910) 273-9668

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:

LEONARD L. WARNER AND
ARLENE L. WARNER,

SS# 075-30-7046

Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373
Adversarial Proceeding
Number: 97-2003

MOTION TO AMEND
COMPLAINT TO DETER
DISCHARGEABILITY OF DEBT

NOW COMES plaintiffs, through counsel, and, prior to the completion of discovery in this case, move the Court to amend plaintiffs' Complaint to Determine Dischargeability of Debt as follows:

To add a Second Claim for Relief and substitute the Prayer for Relief all as set forth in the attached (Proposed) Amendment to Complaint to Determine Dischargeability of Debt.

The primary purposes of this amendment are to 1) add facts revealed through discovery and a related Adversarial Proceeding wherein the Trustee has alleged a corporation owned by defendant Arlene Warner made a substantial fraudulent conveyance to defendants' state court attorneys; 2) add facts revealed by examination of corporate records and other documents abandoned by defendants in the attic of their former home; 3) set forth facts showing defendants committed fraud and fraud by omission when defendants induced plaintiffs to accept a $100,000.00 Promissory Note; and 4) more clearly set forth the acts of defendant Arlene L. Warner that subject her to liability to plaintiffs and reveal why her debt to plaintiffs should be nondischargeable.

WHEREFORE, the plaintiffs pray that their Complaint to Determine Dischargeability of Debt be amended as set forth above.

This the 25th day of June, 1998.

/s/ Harry G. Gordon
Harry G. Gordon,
Attorney for Plaintiffs
State Bar No. 5628

OF COUNSEL:
GORDON LAW OFFICES
Independence Center, Suite 302
400 W. Market Street
Greensboro, NC 27401
Telephone: (336) 275-9910
Facsimile: (336) 275-8797

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:
LEONARD L. WARNER AND
ARLENE L. WARNER,
SS# 075-30-7046
Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373
Adversarial Proceeding
Number: 97-2003

(PROPOSED)
AMENDMENT TO COMPLAINT TO DETERMINE
DISCHARGEABILITY OF DEBT

SECOND CLAIM FOR RELIEF

19. Plaintiff repeats and realleges paragraph 1 through 18 of the Complaint.

20. The essential claim. asserted in the state court action, A.E. Archer Companies, Inc. A. Elliott Archer and Carol A. Archer vs. Warner Manufacturing, Inc., Leonard L. Warner, Stuart E. Warner, Arlene Warner and Webb Lexington Corp., 92 CvS 7777 (Superior Court; Guilford County), was that the defendants, conspiring together, purchased a distressed business in December of 1991 for $250,000.00, significantly altered the financial records of the former business to restate the prior owner's earning from (-) $129,951.69 to

(+) $38,376.00, offered the business for sale with "recast" financials for $1.24 million about two (2) months after the purchase, and then in May of 1992, about six (6) months of making the purchase for $250,000.00, resold the business for $685,000.00 to a company formed by plaintiff A. Elliott Archer. Plaintiffs personally guaranteed a $500,000.00 bank loan to make the purchase, and plaintiffs were seriously damaged financially, mentally and emotionally by the actions of defendants.

21. Defendant Leonard Warner was indicted by the State of North Carolina for felony obtaining property by false pretenses in connection with the purchase and resale of the business in question.

22. On information and belief, although Arlene Warner was never indicted, records produced in discovery and the sworn testimony of the Warners established as fact that Arlene Warner was a director and officer and owned fifty (50%) of Warner Manufacturing, Inc., the very corporation that purchased the distressed business for $250,000.00, "recast" the financials, offered it for $1.24 million, and resold it to Archer Companies six months later for $685,000.00.

23. On information and belief, although Arlene Warner was never indicted, records produced in discovery and the sworn testimony of the parties established as fact that Arlene Warner was a director and Vice-President and Secretary and owned one hundred (100%) percent of the stock of Webb Lexington Corp., the corporation that received from Warner Manufacturing, Inc. two checks totaling $282,750.00 one day after the sale of the business to Archer Companies.

24. On information and belief, Arlene Warner is a college graduate, has taken a college course in accounting, and is the President and was in 1992 the sole owner of her own incorporated business, being Arlene Warner Designs, Inc.

25. On information and belief, defendant Arlene Warner was the sole shareholder, a director, and for a number of years the President of Alarmmaster, Inc. a company operated

by defendant Leonard Warner from approximately 1970 to 1988, and defendant Arlene Warner received all or virtually all of the proceeds of sale, in excess of $150,000.00, when that business was sold in 1988.

26. On information and belief, defendant Arlene Warner was a fifty percent (50%) shareholder, a director, and an officer of Central Communications, Inc., a company operated by defendant Leonard Warner from approximately 1977 to 1988, and defendant Arlene Warner received fifty percent (50%) of the proceeds of sale when that business was sold in 1988.

27. On information and belief, on December 10, 1991, Arlene Warner as corporate secretary of Warner Manufacturing, Inc. signed closing documents in connection with the purchase of the business in question for $250,000.00, which business was two (2) months later offered for sale for $1.24 million and in May of 1992 sold to Archer Companies for $685,000.00.

28. On information and belief, on or about December 10, 1991, Arlene Warner as corporate secretary of Warner Manufacturing, Inc. signed on behalf of Warner Manufacturing, Inc. a $100,000.00 Promissory Note bearing 9% interest and a closing statement, both reflecting a $200,000.00 debt by Warner Manufacturing, Inc. to the seller of the business in question, which debt was subsequently omitted from the balance sheets and income statements of Warner Manufacturing, Inc. when the financial statements were provided to plaintiffs.

29. On information and belief, Arlene Warner was in 1992 the Vice-President, Treasurer, and Secretary of Webb Lexington Corp., and she was the 100% shareholder of Webb Lexington Corp. and one of the two directors, together with Leonard Warner, her husband.

30. On information and belief, Webb Lexington Corp. was in 1992 a corporation owned 100% by defendant Arlene Warner with no employees and no discernable business pur-

pose for existing separate and apart from transferring monies among the Warners and their companies.

31. On information and belief, documents produced in discovery by Webb Lexington Corp. (owned 100% by Arlene Warner) and Warner Manufacturing, Inc. (owned 50% by Arlene Warner) included checks showing hundreds of thousands of dollars paid to Arlene Warner's corporation, Webb Lexington Corp., by Warner Manufacturing, Inc. for labor costs of Warner Manufacturing, Inc., all disguised as consulting fees and management fees paid by Warner Manufacturing, Inc. to Webb Lexington Corp.

32. On information and belief, defendant Arlene Warner's corporation, Webb Lexington Corp., received from Warner Manufacturing on May 23, 1992, one day after the closing with plaintiffs, check #1109 for $102,750.00 and check #1110 for $180,000.00. Defendant Arlene Warner also received in some fashion a $390,000.00 loan from Webb Lexington Corp. as evidenced by a September 16, 1992 check from Webb Lexington Corp. to High Point Bank and Trust Company bearing the notation "loan AW."

33. On information and belief, promptly after the closing at which time Archer Companies paid $685,000.00 for the business purchased six months earlier for $250,000.00 was the $390,000.00 transfer of funds from Webb Lexington Corp. related to the acquisition by Arlene Warner of Full Knit Hosiery Mills. Defendant Arlene Warner became the sole owner of the Full Knit Hosiery Mills.

34. On information and belief, Webb Lexington Corp., Arlene Warner and son Stuart Warner were the primary beneficiaries of the conduct by Leonard Warner that resulted in defendant Leonard Warner being indicted for felony obtaining property by false pretenses.

35. Suit in state court was initially filed against only defendant Leonard Warner and the Warners' corporation. After discovery revealed the involvement of defendant Arlene Warner and the additional corporations owned by defendant

Arlene Warner, plaintiffs filed an Amended Complaint against both defendants, their corporation, and Webb Lexington Corporation, a corporation owned 100% by defendant Arlene Warner, and in which she was Director, Vice President, and Corporate Secretary. The suit in state court and felony criminal proceedings commenced in state court against defendant Leonard Warner was settled on the eve of trial based on restitution/settlement amount of $300,000.00, being $200,000.00 cash and $100,000.00 over time. To induce plaintiffs to finance the $100,000.00 of the $300,000.00 restitution/settlement, defendants provided a Deed of Trust on their home and also on real property owned by Hosiery Industries, Inc., another corporation owned by defendants.

36. In consideration for defendants agreeing to make restitution to plaintiffs in the total amount of $300,000.00, including signing the Promissory Note and Deed of Trust referenced above, plaintiffs consented to the dismissal of an indictment against defendant Leonard L. Warner for obtaining property by false pretenses in violation of criminal statute G.S. §14-100, plaintiffs agreed that plaintiff would take no action to cause criminal proceedings to be brought against defendant Arlene Warner or any defendant; and plaintiffs agreed not to pursue further plaintiffs' claims for fraud, misrepresentation and the like.

37. The "Settlement Agreement" signed by plaintiffs and defendants on or about the same date they signed the $100,000.00 Promissory Note contains the following language about criminal actions:

> The parties further agree that this Settlement Agreement shall be null and void if the pending criminal action is not dismissed by the State of North Carolina..... Mr. Gordon expressly agrees not to disburse any amount whatsoever from the escrow account or release the Note or Deeds of Trust therefrom to any person unless and until the criminal action has been dismissed with prejudice

and the terms and conditions of the settlement have been met.

38. The "General Release" signed by plaintiffs and defendants on or about the same date they signed the $100,000.00 Promissory Note expressly recites that plaintiffs had claims "for emotional distress/personal-injury-type damages they claimed to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction of emotional distress...." The parties then acknowledged that all sums paid and to be paid "constitute payment for claims of damages resulting from personal injuries or sickness or mental and emotional distress in a case involving prosecution of a legal suit or action based upon tort or tort type rights...."

39. Defendants failed to reveal to Plaintiff that, prior to signing the $100,000.00 Promissory Note and Deed of Trust, defendants caused a Deed of Trust to be executed in favor of defendants' state court counsel to guaranty payment of defendants' attorneys.

40. When defendants later filed bankruptcy, plaintiffs learned defendants had, unbeknownst to them, placed a substantial lien in favor of their (state court) counsel on the real property of Webb Lexington Corporation, and there was very little equity in the real property owned by Hosiery Industries, Inc.

41. On March 20, 1998, Charles M. Ivey, III, Trustee of the estate of Webb Lexington Corporation, filed a suit against Tuggle, Duggins & Meschan, P.A., former state court counsel for defendants. See Adversary Proceeding No. 98-2020 in Case No. B-96-10356C-7G, United States Bankruptcy Court for the Middle District of North Carolina.

42. The pleadings of the Trustee in Adversary Proceeding No. 98-2020 allege that a) defendant Leonard Warner and defendant Arlene Warner's wholly-owned corporation, Webb-Lexington, Inc., signed a $100,000.00 "future advances" Note to the defendants' state court attorneys prior to the date defendants induced plaintiffs to agree to finance

$100,000.00 of the $300,000.00 restitution/settlement amount; b) the Future Advances Note was secured by a first lien on real property of Webb Lexington Corporation; c) only $18,377.54 was owed when the $100,000.00 future advance Note was signed; d) $40,000.00 was paid to defendants' state court counsel on the secured future advances Note on or about February 22, 1996, after defendants signed the Note to plaintiff and after defendants filed for protection under the Bankruptcy Act; e) the Deed of Trust was provided by Webb Lexington Corporation for no value or consideration and is void and invalid; f) the Deed of Trust by Webb Lexington Corporation was made with actual intent on the part of the corporation to defraud creditors and was made at a time when Webb Lexington Corporation did not retain sufficient property to pay its remaining creditors, and the execution and delivery of the Deed of Trust to defendants' state court attorney and payments thereon constituted fraudulent conveyances under N.C.G.S. §39-15.

43. The pleadings of defendant Tuggle, Duggins & Meschan, PA in Adversary Proceeding No. 98-2020 allege that, based on information available to defendant Arlene Warner's own state court counsel, the doctrine of alter ego applies, and "Webb Lexington Corporation was a mere instrumentality of Leonard Warner, was under capitalized, and failed to follow corporate formalities." On information and belief, defendant Arlene Warner, not defendant Leonard Warner, was the one hundred percent (100%) owner of Webb Lexington Corporation as well as an officer and director with defendant Leonard Warner and the doctrine of alter ego also applies to defendant Arlene Warner.

44. On information and belief, at or about the same time defendants represented to plaintiffs they could only borrow or otherwise come up with $200,000.00 of the agreed $300,000.00 restitution/settlement amount to be paid, one or both defendants in fact borrowed approximately $50,000.00 on the eve of signing the $100,000.00 Promissory Note to plaintiffs, which $50,000.00 was used to pay monies owed to

defendants' state court counsel, and this $50,000.00 loan was not disclosed to plaintiffs and seriously impacted defendants ability to pay the $100,000.00 Note to plaintiffs.

45. Defendants were counseled in the state court litigation by experienced bankruptcy counsel who did not reveal to plaintiffs the $50,000.00 loan to pay defendants' counsel or the lien defendants' counsel put in place for itself; on information and belief, defendants induced plaintiffs to finance the $100,000.00 amount with no intent to honor the obligation at the time the Note was signed by defendants.

46. Plaintiffs would not have agreed to accept a $100,000.00 Promissory Note from defendants had plaintiffs known about the $50,000.00 loan to pay defendants' counsel or the substantial lien defendants caused to be placed on the real estate of Webb Lexington Corporation, Inc., a corporation owned 100% by defendant Arlene Warner and a substantial asset of defendant Arlene Warner who was personally obligated on the Note.

47. Plaintiffs would not have agreed to accept a $100,000.00 Promissory Note from defendants had plaintiffs known about the substantial lien defendants caused to be placed on the real estate of Webb Lexington Corporation, Inc., which effectively gave defendants' state court counsel a superior lien position to plaintiffs on the "assets of defendant Arlene Warner."

48. On information and belief, defendants induced plaintiffs to extend credit and accept a $100,000.00 Promissory Note/loan arrangement with no present intention to pay the same, and defendants in fact filed bankruptcy without ever paying any part of principal or interest on the Note, and promptly after filing bankruptcy defendants used available assets to pay $40,000.00 to the very attorneys who crafted in significant part the financed portion of the restitution/settlement arrangement.

49. Defendants engaged in actual fraud, fraud by omission, false pretenses, false representation, obtaining property

(money) by false pretenses, larceny by trick and deceit; and ultimately fraudulently induced plaintiffs to accept a $100,000.00 Promissory Note as part of a settlement/restitution arrangement for criminal and civil fraud claims; and defendants willfully and maliciously caused plaintiffs great financial loss and severe mental and emotional distress and suffering.

50. Plaintiffs agreed to the Promissory Note arrangement believing it to be a restitution arrangement for losses they sustained by virtue of the fraud and criminal conduct of defendants. The documents signed as part of the settlement/ restitution arrangement clearly reflect the criminal and civil fraud clauses, and plaintiffs understood the release to be effective if and only if defendants made complete payment and restitution as per the agreed terms.

51. Defendants are not entitled to a discharge as to their debt to the plaintiffs as the United States Bankruptcy Code, Title II, §523(a) provides that a discharge under Chapter 7 does not discharge an individual from any debt:

> (2) for money, property, services, or an extension, renewal or refinancing of credit; to the extent obtained by (a) false pretenses, a false representation, or actual fraud,
>
> (4) for fraud or defalcation while acting in fiduciary capacity, embezzlement; or larceny,
>
> (6) for willful and malicious injury by the debtor to another entity …

52. The actions of defendants, including but not limited to inducing plaintiffs to accept the Promissory Note, constitute false representation or concealment by defendants of a material fact; made with knowledge of its falsity or in culpable ignorance of its truth, made with the intent that it should be acted upon by plaintiffs, and plaintiffs justifiably and reasonably relied and acted upon the misrepresentation, resulting in injury to plaintiffs in that plaintiffs suffered substantial losses in 1992 and additional losses when the $100,000.00

Promissory Note proved uncollectible in large part due to the loans to pay and the undisclosed substantial secured debt in favor of defendants' state court attorneys.

53. On information and belief, defendants caused and permitted Webb Lexington Corporation, defendant Arlene Warner's wholly-owned corporation, to engage in a fraudulent conveyance.

54. On information and belief, defendants Arlene Warner and Leonard Warner conspired with each other to deceive plaintiffs and induce plaintiffs to purchase a business from defendants, defendants conspired to do the acts alleged in this pleading, and defendants conspired to do unlawful acts or to do lawful acts in an unlawful manner. The conduct of defendants as alleged in this Complaint constitute acts in furtherance of the conspiracy.

55. As conspirators, the acts of each conspirator, defendant Leonard Warner and defendant Arlene Warner, becomes the acts of each co-conspirator.

56. Defendants are liable to plaintiffs for conspiracy to commit torts (fraud) and criminal acts and for acts in furtherance of the conspiracy for an amount in excess of $10,000.00 for all expenses, losses, and damages plaintiffs has suffered as a result of defendants' acts in furtherance of the conspiracy, and defendants are liable for punitive damages.

57. On information and belief, defendants Arlene Warner and Leonard Warner operated Webb Lexington Corporation, Warner Manufacturing, Inc., and Full Knit Hosiery Mills, Inc. as an instrumentality or alter ego of themselves as sole shareholders, with defendants Arlene Warner and Leonard Warner exercising such complete domination of the policy and business practices of the corporations that the corporations had no mind, will or existence of their own separate and apart from defendants Arlene Warner and Leonard Warner.

58. On information and belief, defendants inadequately capitalized the controlled corporations, defendants siphoned

corporate funds to themselves, defendants did not maintain adequate corporate records, and the controlled corporations were at all relevant times insolvent.

59. On information and belief, the individual defendants controlled the corporations in such a way as to commit a fraud or wrong, the control and breach of duty proximately caused the injury complained of, and the corporate veils should be disregarded to hold accountable the individual defendants who engaged in the acts complained of as to do otherwise would result in injustice and be fundamentally unfair.

WHEREFORE, the plaintiffs pray:

1. That defendants be required to give a full and complete accounting of all transfers of property, borrowings, future advances, and use of funds at or about the time defendants signed the settlement/restitution agreements with plaintiffs;

2. That the debt owed to plaintiffs by defendants be determined to be excepted from discharge under 11 U.S.C. Section 523(a);

3. That plaintiffs have and recover of defendants reasonable attorneys' fees.

4. That plaintiffs have and recover of defendants the costs of this action to be taxed by the Clerk.

5. That in the alternative, if defendant Arlene Warner's obligation to plaintiffs is determined to be discharged in Bankruptcy, that plaintiffs be declared released from any agreement and obligation try take no action to cause criminal proceedings to be brought against Arlene Warner or her son, Stuart Warner.

6. That plaintiffs have and recover of and from defendants such other and further relief as to the Court may seem just and proper.

This the 25th day of June, 1998.

/s/ Harry G. Gordon
Harry G. Gordon,
Attorney for Plaintiffs
State Bar No. 5628

OF COUNSEL:
GORDON LAW OFFICES
Independence Center, Suite 302
400 W. Market Street
Greensboro, NC 27401
Telephone: (336) 275-9910
Facsimile: (336) 275-8797

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:
Leonard L. Warner and
Arlene L. Warner, Debtors.

A. Elliott Archer and
Carol A. Archer, Plaintiffs,
v.
Leonard L. Warner and
Arlene L. Warner, Defendants.

Case No. 96-10373C-7G
Adversary No. 97-2003

ORDER

This adversary proceeding came before the court on September 15, 1998, for hearing upon a motion by plaintiffs to file amended complaint, a motion by plaintiffs to compel discovery and a motion by defendant Arlene L. Warner for summary judgment. When this adversary proceeding was called for hearing, no attorneys or parties were present in court to prosecute the motions which were scheduled for hearing. The motions, therefore, were denied in open court. Pursuant to such ruling, the motion by plaintiffs to file amended complaint is denied, the motion by plaintiffs to compel discovery is denied and the motion by defendant Arlene L. Warner for summary judgment is denied.

This 5th day of October, 1998.

/s/ William L. Stocks [STAMP]
WILLIAM L. STOCKS
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:
LEONARD L. WARNER AND
ARLENE L. WARNER,
SS# 075-30-7046
Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373
Adversarial Proceeding
Number: 97-2003

RENEWED MOTION TO AMEND COMPLAINT
TO DETERMINE DISCHARGEABILITY OF DEBT

NOW COMES plaintiffs, through counsel, for good cause and for the reasons set forth in the accompanying Objection to "Second" Motion for Summary Judgment by Defendant Arlene L. Warner, hereby renew plaintiffs' Motion to Amend Complaint to Determine Dischargeability of Debt.

Plaintiffs, through counsel, renews its Motion made prior to the completion of discovery in this case to amend plaintiffs' Complaint to Determine Dischargeability of Debt as follows:

To add a Second Claim for Relief and substitute the Prayer for Relief all as set forth in the attached

(Proposed) Amendment to Complaint to Determine Dischargeability of Debt.

The primary purposes of this amendment are to 1) add facts revealed through discovery and a related Adversarial Proceeding wherein the Trustee has alleged a corporation owned by defendant Arlene Warner made a substantial fraudulent conveyance to defendants' state court attorneys; 2) add facts revealed by examination of corporate records and other documents abandoned by defendants in the attic of their former home; 3) set forth facts showing defendants committed fraud and fraud by omission when defendants induced plaintiffs to accept a $ 100,000.00 Promissory Note; and 4) more clearly set forth the acts of defendant Arlene L. Warner that subject her to liability to plaintiffs and reveal why her debt to plaintiffs should be nondisch. rgeable.

WHEREFORE, the plaintiffs pray that their Complaint to Determine Dischargeability of Debt be amended as set forth above.

This the 27th day of May, 1999.

/s/ Harry G. Gordon
Harry G. Gordon,
Attorney for
A. Elliott Archer and
Carol A. Archer

OF COUNSEL:

GORDON LAW OFFICES
400 W. Market Street, Suite 302
Greensboro, North Carolina 27401
Telephone: (336) 275-9910
Facsimile: (336) 275-8797

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:
LEONARD L. WARNER AND
ARLENE L. WARNER,

SS# 075-30-7046

Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

vs.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373
Adversarial Proceeding
Number: 97-2003

[FILED: May 27, 1999]

(PROPOSED)
AMENDMENT TO COMPLAINT TO
DETERMINE DISCHARGEABILITY OF DEBT

SECOND CLAIM FOR RELIEF

19. Plaintiff repeats and realleges paragraph 1 through 18 of the Complaint.

20. The essential claim asserted in the state court action, A.E. Archer Companies, Inc. A. Elliott Archer and Carol A. Archer vs. Warner Manufacturing, Inc., Leonard L. Warner, Stuart E. Warner, Arlene Warner and Webb Lexington Corp.,

92 CvS 7777 (Superior Court, Guilford County), was that the defendants, conspiring together, purchased a distressed business in December of 1991 for $250,000.00, significantly altered the financial records of the former business to restate the prior owner's earning from (-) $129,951.69 to (+) $38,376.00, offered the business for sale with "recast" financials for $1.24 million about two (2) months after the purchase, and then in May of 1992, about six (6) months of making the purchase for $250,000.00, resold the business for $685,000.00 to a company formed by plaintiff A. Elliott Archer. Plaintiffs personally guaranteed a $500,000.00 bank loan to make the purchase, and plaintiffs were seriously damaged financially, mentally and emotionally by the actions of defendants.

21. Defendant Leonard Warner was indicted by the State of North Carolina for felony obtaining property by false pretenses in connection with the purchase and resale of the business in question.

22. On information and belief, although Arlene Warner was never indicted, records produced in discovery and the sworn testimony of the Warners established as fact that Arlene Warner was a director and officer and owned fifty (50%) of Warner Manufacturing, Inc., the very corporation that purchased the distressed business for $250,000.00, "recast" the financials, offered it for $1.24 million, and resold it to Archer Companies six months later for $685,000.00.

23. On information and belief, although Arlene Warner was never indicted, records produced in discovery and the sworn testimony of the parties established as fact that Arlene Warner was a director and Vice-President and Secretary and owned one hundred (100%) percent of the stock of Webb Lexington Corp., the corporation that received from Warner Manufacturing, Inc. two checks totaling $282,750.00 one day after the sale of the business to Archer Companies.

24. On information and belief, Arlene Warner is a college graduate, has taken a college course in accounting, and

is the President and was in 1992 the sole owner of her own incorporated business, being Arlene Warner Designs, Inc.

25. On information and belief, defendant Arlene Warner was the sole shareholder, a director, and for a number of years the President of Alarmmaster, Inc. a company operated by defendant Leonard Warner from approximately 1970 to 1988, and defendant Arlene Warner received all or virtually all of the proceeds of sale, in excess of $150,000.00, when that business was sold in 1988.

26. On information and belief, defendant Arlene Warner was a fifty percent (50%) shareholder, a director, and an officer of Central Communications, Inc., a company operated by defendant Leonard Warner from approximately 1977 to 1988, and defendant Arlene Warner received fifty percent (50%) of the proceeds of sale when that business was sold in 1988.

27. On information and belief, on December 10, 1991, Arlene Warner as corporate secretary of Warner Manufacturing, Inc. signed closing documents in connection with the purchase of the business in question for $250,000.00, which business was two (2) months later offered for sale for $1.24 million and in May of 1992 sold to Archer Companies for $685,000.00.

28. On information and belief, on or about December 10, 1991, Arlene Warner as corporate secretary of Warner Manufacturing, Inc. signed on behalf of Warner Manufacturing, Inc. a $100,000.00 Promissory Note bearing 9% interest and a closing statement, both reflecting a $100,000.00 debt by Warner Manufacturing, Inc. to the seller of the business in question, which debt was subsequently omitted from the balance sheets and income statements of Warner Manufacturing, Inc. when the financial statements were provided to plaintiffs.

29. On information and belief, Arlene Warner was in 1992 the Vice-President, Treasurer, and Secretary of Webb Lexington Corp., and she was the 100% shareholder of Webb

Lexington Corp. and one of the two directors, together with Leonard Warner, her husband.

30. On information and belief, Webb Lexington Corp. was in 1992 a corporation owned 100% by defendant Arlene Warner with no employees and no discernable business purpose for existing separate and apart from transferring monies among the Warners and their companies.

31. On information and belief, documents produced in discovery by Webb Lexington Corp, (owned 100% by Arlene Warner) and Warner Manufacturing, Inc. (owned 50% by Arlene Warner) included checks showing hundreds of thousands of dollars paid to Arlene Warner's corporation, Webb Lexington Corp., by Warner Manufacturing, Inc. for labor costs of Warner Manufacturing, Inc., all disguised as consulting fees and management fees paid by Warner Manufacturing, Inc. to Webb Lexington Corp.

32. On information and belief, defendant Arlene Warner's corporation, Webb Lexington Corp., received from Warner Manufacturing on May 23, 1992, one day after the closing with plaintiffs, check #1109 for $102,750.00 and check #1110 for $180,000.00. Defendant Arlene Warner also received in some fashion a $390,000.00 loan from Webb Lexington Corp. as evidenced by a September 16, 1992 check from Webb Lexington Corp. to High Point Bank and Trust Company bearing the notation "loan AW."

33. On information and belief, promptly after the closing at which time Archer Companies paid $685,000.00 for the business purchased six months earlier for $250,000.00 was the $390,000.00 transfer of funds from Webb Lexington Corp. related to the acquisition by Arlene Warner of Full Knit Hosiery Mills. Defendant Arlene Warner became the sole owner of the Full Knit Hosiery Mills.

34. On information and belief, Webb Lexington Corp., Arlene Warner and son Stuart Warner were the primary beneficiaries of the conduct by Leonard Warner that resulted

in defendant Leonard Warner being indicted for felony obtaining property by false pretenses.

35. Suit in state court was initially filed against only defendant Leonard Warner and the Warners' corporation. After discovery revealed the involvement of defendant Arlene Warner and the additional corporations owned by defendant Arlene Warner, plaintiffs filed an Amended Complaint against both defendants, their corporation, and Webb Lexington Corporation, a corporation owned 100% by defendant Arlene Warner, and in which she was Director, Vice President, and Corporate Secretary. The suit in state court and felony criminal proceedings commenced in state court against defendant Leonard Warner was settled on the eve of trial based on restitution/settlement amount of $300,000.00, being $200,000.00 cash and $100,000.00 over time. To induce plaintiffs to finance the $100,000.00 of the $300,000.00 restitution/settlement, defendants provided a Deed of Trust on their home and also on real property owned by Hosiery Industries, Inc., another corporation owned by defendants.

36. In consideration for defendants agreeing to make restitution to plaintiffs in the total amount of $300,000.00, including signing the Promissory Note and Deed of Trust referenced above, plaintiffs consented to the dismissal of an indictment against defendant Leonard L. Warner for obtaining property by false pretenses in violation of criminal statute G.S. § 14-100, plaintiffs agreed that plaintiff would take no action to cause criminal proceedings to be brought against defendant Arlene Warner or any defendant, and plaintiffs agreed not to pursue further plaintiffs' claims for fraud, misrepresentation and the like.

37. The "Settlement Agreement" signed by plaintiffs and defendants on or about the same date they signed the $100,000.00 Promissory Note contains the following language about criminal actions:

> The parties further agree that this Settlement Agreement shall be null and void if the pending criminal action is not dismissed by the State of North Carolina..... Mr. Gordon expressly agrees not to disburse any amount whatsoever from the escrow account or release the Note or Deeds of Trust therefrom to any person unless and until the criminal action has been dismissed with prejudice and the terms and conditions of the settlement have been met.

38. The "General Release" signed by plaintiffs and defendants on or about the same date they signed the $100,000.00 Promissory Note expressly recites that plaintiffs had claims "for emotional distress/personal-injury-type damages they claimed to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction of emotional distress...." The parties then acknowledged that all sums paid and to be paid "constitute payment for claims of damages resulting from personal injuries or sickness or mental and emotional distress in a case involving prosecution of a legal suit or action based upon tort or tort-type rights...."

39. Defendants failed to reveal to Plaintiff that, prior to signing the $100,000.00 Promissory Note and Deed of Trust, defendants caused a Deed of Trust to be executed in favor of defendants' state court counsel to guaranty payment of defendants' attorneys.

40. When defendants later filed bankruptcy, plaintiffs learned defendants had, unbeknownst to them, placed a substantial lien in favor of their (state court) counsel on the real property of Webb Lexington Corporation, and there was very little equity in the real property owned by Hosiery Industries, Inc.

41. On March 10, 1998, Charles M. Ivey, III, Trustee of the estate of Webb Lexington Corporation, filed a suit against Tuggle, Duggins & Meschan, P.A., former state court counsel for defendants. See Adversary Proceeding No. 98-2020 in Case No. B-96-10356C-7G, United States Bankruptcy Court for the Middle District of North Carolina.

42. The pleadings of the Trustee in Adversary Proceeding No. 98-2020 allege that a) defendant Leonard Warner and defendant Arlene Warner's wholly-owned corporation, Webb-Lexington, Inc., signed a $100,000.00 "future advances" Note to the defendants' state court attorneys prior to the date defendants induced plaintiffs to agree to finance $100,000,00 of the $300,000.00 restitution/settlement amount; b) the Future Advances Note was secured by a first lien on real property of Webb Lexington Corporation; c) only $18,377.54 was owed when the $100,000.00 future advance Note was signed; d) $40,000.00 was paid to defendants' state court counsel on the secured future advances Note on or about February 22, 1996, after defendants signed the Note to plaintiff and after defendants filed for protection under the Bankruptcy Act; e) the Deed of Trust was provided by Webb Lexington Corporation for no value or consideration and is void and invalid; f) the Deed of Trust by Webb Lexington Corporation was made with actual intent on the part of the corporation to defraud creditors and was made at a time when Webb Lexington Corporation did not retain sufficient property to pay its remaining creditors, and the execution and delivery of the Deed of Trust to defendants' state court attorney and payments thereon constituted fraudulent conveyances under N.C.G.S. §39-15.

43. The pleadings of defendant Tuggle, Duggins & Meschan, PA in Adversary Proceeding No. 98-2020 allege that, based on information available to defendant Arlene Warner's own state court counsel, the doctrine of alter ego applies, and "Webb Lexington Corporation was a mere instrumentality of Leonard Warner, was under capitalized, and failed to follow corporate formalities." On information and belief, defendant Arlene Warner, not defendant Leonard Warner, was the one hundred percent (100%) owner of Webb Lexington Corporation as well as an officer and director with defendant Leonard Warner and the doctrine of alter ego also applies to defendant Arlene Warner.

44. On information and belief, at or about the same time defendants represented to plaintiffs they could only borrow or otherwise come up with $200,000.00 of the agreed $300,000.00 restitution/settlement amount to be paid, one or both defendants in fact borrowed approximately $50,000.00 on the eve of signing the $100,000.00 Promissory Note to plaintiffs, which $50,000.00 was used to pay monies owed to defendants' state court counsel, and this $50,000.00 loan was not disclosed to plaintiffs and seriously impacted defendants ability to pay the $100,000.00 Note to plaintiffs.

45. Defendants were counseled in the state court litigation by experienced bankruptcy counsel who did not reveal to plaintiffs the $50,000.00 loan to pay defendants' counsel or the lien defendants' counsel put in place for itself; on information and belief, defendants induced plaintiffs to finance the $100,000.00 amount with no intent to honor the obligation at the time the Note was signed by defendants.

46. Plaintiffs would not have agreed to accept a $100,000.00 Promissory Note from defendants had plaintiffs known about the $50,000.00 loan to pay defendants' counsel or the substantial lien defendants's [sic] caused to be placed on the real estate of Webb Lexington Corporation, Inc., a corporation owned 100% by defendant Arlene Warner and a substantial asset of defendant Arlene Warner who was personally obligated on the Note.

47. Plaintiffs would not have agreed to accept a $100,000.00 Promissory Note from defendants had plaintiffs known about the substantial lien defendants caused to be placed on the real estate of Webb Lexington Corporation, Inc., which effectively gave defendants' state court counsel a superior lien position to plaintiffs on the "assets of defendant Arlene Warner."

48. On information and belief, defendants induced plaintiffs to extend credit and accept a $100.000.00 Promissory Note/loan arrangement with no present intention to pay the same, and defendants in fact filed bankruptcy without

ever paying any part of principal or interest on the Note, and promptly after filing bankruptcy defendants used available assets to pay $40,000.00 to the very attorneys who crafted in significant part the financed portion of the restitution/settlement arrangement,

49. Defendants engaged in actual fraud, fraud by omission, false pretenses, false representation, obtaining property (money) by false pretenses, larceny by trick and deceit, and ultimately fraudulently induced plaintiffs to accept a $100,000.00 Promissory Note as part of a settlement/restitution arrangement for criminal and civil fraud claims; and defendants willfully and maliciously caused plaintiffs great financial loss and severe mental and emotional distress and suffering.

50. Plaintiffs agreed to the Promissory Note arrangement believing it to be a restitution arrangement for losses they sustained by virtue of the fraud and criminal conduct of defendants. The documents signed as part of the settlement/restitution arrangement clearly reflect the criminal and civil fraud clauses, and plaintiffs understood the release to be effective if and only if defendants made complete payment and restitution as per the agreed terms.

51. Defendants are not entitled to a discharge as to their debt to the plaintiffs as the United States Bankruptcy Code, Title II, §523(a) provides that a discharge under Chapter 7 does not discharge an individual from any debt:

> (2) for money, property, services, or an extension, renewal or refinancing of credit, to the extent obtained by (a) false pretenses, a false representation, or actual fraud,
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52. The actions of defendants, including but not limited to inducing plaintiffs to accept the Promissory Note, constitute false representation or concealment by defendants of a material fact, made with knowledge of its falsity or in culpable ignorance of its truth, made with the intent that it should be acted upon by plaintiffs, and plaintiffs justifiably and reasonably relied and acted upon the misrepresentation, resulting in injury to plaintiffs in that plaintiffs suffered substantial losses in 1992 and additional losses when the $100,000.00 Promissory Note proved uncollectible in large part due to the loans to pay and the undisclosed substantial secured debt in favor of defendants' state court attorneys.

53. On information and belief, defendants caused and permitted Webb Lexington Corporation, defendant Arlene Warner's wholly-owned corporation, to engage in a fraudulent conveyance.

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55. As conspirators, the acts of each conspirator, defendant Leonard Warner and defendant Arlene Warner, becomes the acts of each co-conspirator.

56. Defendants are liable to plaintiffs for conspiracy to commit torts (fraud) and criminal acts and for acts in furtherance of the conspiracy for an amount in excess of $10,000.00 for all expenses, losses, and damages plaintiffs has suffered as a result of defendants' acts in furtherance of the conspiracy, and defendants are liable for punitive damages.

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nard Warner exercising such complete domination of the policy and business practices of the corporations that the corporations had no mind, will or existence of their own separate and apart from defendants Arlene Warner and Leonard Warner.

58. On information and belief, defendants inadequately capitalized the controlled corporations, defendants siphoned corporate funds to themselves, defendants did not maintain adequate corporate records, and the controlled corporations were at all relevant times insolvent.

59. On information and belief, the individual defendants controlled the corporations in such a way as to commit a fraud or wrong, the control and breach of duty proximately caused the injury complained of, and the corporate veils should be disregarded to hold accountable the individual defendants who engaged in the acts complained of as to do otherwise would result in injustice and be fundamentally unfair.

WHEREFORE, the plaintiffs pray:

1. That defendants be required to give a full and complete accounting of all transfers of property, borrowings, future advances, and use of funds at or about the time defendants signed the settlement/restitution agreements with plaintiffs;

2. That the debt owed to plaintiffs by defendants be determined to be excepted from discharge under 11 U.S.C. Section 523(a);

3. That plaintiffs have and recover of defendants reasonable attorneys' fees.

4. That plaintiffs have and recover of defendants the costs of this action to be taxed by the Clerk.

5. That in the alternative, if defendant Arlene Warner's obligation to plaintiffs is determined to be discharged in Bankruptcy, that plaintiffs be declared released from any agreement and obligation to take no action to cause criminal

proceedings to be brought against Arlene Warner or her son, Stuart Warner.

6. That plaintiffs have and recover of and from defendants such other and further relief as to the Court may seem just and proper.

This the ____ day of _____ 1999.

_____

Harry G. Gordon,
Attorney for Plaintiffs
State Bar No. 5628

OF COUNSEL:

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UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:
LEONARD L. WARNER AND
ARLENE L. WARNER, Debtors.

A. ELLIOTT ARCHER AND
CAROL A. ARCHER, Plaintiffs,

v.

LEONARD L. WARNER AND
ARLENE L. WARNER, Defendants.

Case No. 96-10373C-7
Adversarial Proceeding
Number: 97-2003

AFFIDAVIT OF HARRY G. GORDON

Harry G. Gordon, being first duly sworn, says:

1. I am an individual, a U.S. Citizen, and I make this affidavit of my own personal knowledge.

2. I am counsel for plaintiffs in this proceeding.

3. I have been counsel for the Archers in actions against Arlene Warner and Leonard Warner or their companies that have been going on since 1992.

4. On June 25, 1998, I filed a Motion to amend Complaint to determine Dischargeability of Debt. At that time, discovery had not been completed and there was pending a motion I had filed to compel Arlene Warner to answer interrogatories, identify and produce documents, and properly answer request for admissions.

5. At the initial hearing on the Motion to Compel, the Honorable William Stocks indicated in open court that he would order Arlene Warner to further respond to or supplement discovery responses. Thereafter, Arlene Warner's attorney, Mr. Frank Chut, asked me if he could work with me to resolve our differences informally, and he and I did make good progress toward that end, although our progress was disrupted by the fact that he left private practice.

6. Prior to the Motion to Amend Complaint and Motion to Compel coming on for hearing, attorney Frank Chut left private practice. His wife, attorney Mercedes Chut, took over representation for Arlene Warner. Mrs. Chut advised me that she was not at all familiar with the facts of this complex case, and she requested that I agree to an extension of time in order for her to be prepared to argue and defend the various pending motions. She offered and agreed to appear before the Honorable Williams Stocks and request a continuance if I would consent. Under the circumstances I believed that was the only fair and professional thing to do, and I consented to her request.

7. On October 5, 1998, the date set for the hearing, attorney Mercedes Chut did not arrive at the Bankruptcy Court in time, and the matter came on for hearing before she appeared. As a result, the Honorable William Stocks issued an order denying Plaintiffs' Motion to Compel, Plaintiffs' Motion to Amend Complaint to Determine Dischargeability of Debt, and Defendant Arlene Warner's Motion for Summary Judgment.

8. Thereafter, Mercedes Chut ceased representing Arlene Warner in this matter.

9. This matter received a special setting for trial the week of June 1, 1999. I requested a continuance, which request was denied. On May 25, 1999, I appeared before the Honorable William Stocks to hear a Second Motion to Compel Discovery. At that time he informed me that the Motion to Compel, together with a Motion for Summary Judgment,

would be heard on June 1. I did not understand why the Motion for Summary Judgment was again before the court.

10. On May 26, 1999, attorney Trip Adams, who now represents Arlene Warner, informed me in a telephone call that he had refilled the Motion for Summary Judgment. Neither I nor anyone in my firm had ever received a copy of the "second' Motion for summary Judgment. Attorney Trip Adams faxed it to me that day.

11. My clients have been severely prejudiced by the actions and inactions of Arlene Warner in this matter. On May 27, 1999, I filed Objections to Defendant Arlene Warner's Second Motion for Summary Judgment and I also refilled Plaintiffs' Motion to amend the Complaint to determine Dischargeability of Debt.

This the 28th day of May, 1999.

/s/ Harry G. Gordon
Harry G. Gordon

Sworn and subscribed before me,
this the 28th day of May, 1999.

/s/ Michelle Y. Vincent {NOTARY SEAL}
Notary Public
My Commission Expires: 7/5/2000

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:
Leonard L. Warner and
Arlene L. Warner, Debtors.

A. Elliott Archer and
Carol Archer, Plaintiffs,

v.

Leonard L. Warner and
Arlene L. Warner, Defendants.

Case No. 96-10373C-7G
Adversary No. 97-2003

ORDER

This adversary proceeding came before the court on June 1, 1999, for hearing upon the following motions:

1. Motion by Plaintiffs to Compel Discovery and for Sanctions and to Strike Defenses;
2. Objection by Plaintiffs to Late Filed Exhibits and Witnesses Identified by Defendant Arlene L. Warner;
3. Objection by Defendant Arlene L. Warner to Plaintiffs' Pre-Trial Disclosures;
4. Motion by Defendant Arlene L. Warner for Summary Judgment; and
5. Plaintiffs' Motion to Amend the Complaint.

Harry G. Gordon appeared on behalf of the plaintiffs and Rayford K. Adams, III appeared on behalf of defendant Ar-

lene L. Warner. For the reasons stated in open court, it is ORDERED that all of the foregoing motions shall be and the same hereby are overruled and denied; and it is FURTHER ORDERED that this adversary proceeding be scheduled for trial on June 28, 1999, at 9:30 a.m. in the United States Bankruptcy Court, Courtroom #1, Second Floor, 101 South Edgeworth Street, Greensboro, North Carolina.

This 2nd day of June, 1999.

/s/ William L. Stocks [STAMP]
WILLIAM L. STOCKS
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:
Leonard L. Warner and
Arlene L. Warner, Debtors.

A. Elliott Archer and
Carol Archer, Plaintiffs,

v.

Leonard L. Warner and
Arlene L. Warner, Defendants.

Case No. 96-10373C-7G
Adversary No. 97-2003

[ENTERED: Aug 24, 1999]

ORDER

This adversary proceeding came before the court on August 24, 1999, for hearing upon pending motions at which time the court also conducted a final pre-trial conference. Pursuant to the final pre-trial conference which was conducted, the court is going to sever the issues involved in this case pursuant to Rule 16(c) of the Federal Rules of Civil Procedures which is incorporated into Rule 7016 of the Federal Rules of Bankruptcy Procedure. The issues which are being severed and which will be tried first are the issues involved in the defense in which the defendant asserts that the plaintiffs may not rely upon the misconduct originally alleged against the defendant as grounds for asserting that defendant's obligation under the promissory note attached to the complaint is nondischargeable under §§ 523(a)(2), 523(a)(4)

or 523 (a)(6), based upon the terms and conditions of the settlement in which the defendant executed and delivered the promissory note to the plaintiffs. In this phase of the trial, the parties will be permitted to offer evidence concerning the terms of the settlement pursuant to which the promissory note was delivered to the plaintiffs. If the defendant prevails on this defense, then the dischargeability issue regarding defendant's obligation under the promissory note will be decided in favor of the defendant since the only misconduct alleged against the defendant in this action is the misconduct described in the complaint filed in the original action which is incorporated into the complaint in this action. If the plaintiffs prevail with respect to this defense; the court will then receive evidence regarding the misconduct which is alleged in the original action which the plaintiffs filed against the defendant, and the dischargeability issue will be decided on the basis of such evidence. Having concluded that the issues should be severed and tried in this manner, IT IS SO ORDERED.

This 24th day of August, 1999.

/s/ William L. Stocks [STAMP]
WILLIAM L. STOCKS
United States Bankruptcy Judge

Supreme Court, U.S.
FILED
AUG 8 2002

No. 01-1418

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONERS' BRIEF

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QUESTION PRESENTED

Whether a debt that would otherwise be nondischargeable under Section 523(a) of the Bankruptcy Code (such as a debt for money obtained by means of fraud) becomes dischargeable if the parties enter into a settlement agreement under which the amount of the debt is liquidated.

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IN THE

Supreme Court of the United States

No. 01-1418

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONERS' BRIEF

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit (Pet. App. 1a-15a) is reported at 283 F.3d 230 (4th Cir. 2002). The opinions of the district court (Pet. App. 17a-25a) and the bankruptcy court (Pet. App. 29a-36a) are not reported.

JURISDICTION

The court of appeals entered judgment on March 8, 2002. Petitioners A. Elliott Archer and Carol A. Archer filed a timely petition for a writ of certiorari on March 22, 2002. This Court granted that petition on June 24, 2002. Jurisdiction is proper in this Court pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

11 U.S.C. § 523(a) is reprinted at Pet. App. 43a-48a. Title 11 of the United States Code is referred to herein as the Bankruptcy Code.

STATEMENT

1. Statutory Background.

a. *Nondischargeable debt.* Bankruptcy is intended to provide "honest but unfortunate" debtors with a fresh start. *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998). A "central purpose of the [Bankruptcy] Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (citations and internal quotation omitted). The statutory discharge is the central mechanism available under the Bankruptcy Code to effectuate the fresh start policy for either the individual or reorganized corporate debtor.

Under this mechanism, debts that were due as of the filing of the bankruptcy petition are typically "discharged" at the end of the bankruptcy. *See, e.g.*, 11 U.S.C. §§ 727 (chapter 7 discharge), 1141 (chapter 11 discharge), 1328(b) (chapter 13 discharge). The discharge "operates as an injunction" against any action a creditor might take to collect the discharged debt. 11 U.S.C. § 524.

In the context of individual debtor bankruptcies, in order to limit the discharge to the "honest but unfortunate debtor," *see, e.g.*, *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), the Bankruptcy Code sets forth certain exceptions to the discharge. As specifically applicable here, the Bankruptcy Code excepts from the discharge debts for money obtained by fraud. *See* 11 U.S.C. § 523(a)(2)(A) (the bankruptcy discharge "does not discharge an individual debtor from any

debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud"); *see also* 11 U.S.C. § 523(a)(4).

If the bankruptcy court determines that a debt is nondischargeable, the creditor may continue its attempts to collect on the debt even after the close of the bankruptcy case. Congress concluded that "the creditors' interest in recovering full payment of debts in these categories outweighed the debtors' interest in a complete fresh start." *Grogan*, 498 U.S. at 287. Reflecting the longstanding view that the fresh start is limited to the "honest but unfortunate" debtor, many (though not all) of the categories of nondischargeability relate to fraudulent, tortious or other wrongful behavior by debtors.

Specifically, in addition to the fraud exception set forth in Section 523(a)(2), the Code contains 17 other categories of nondischargeable debts. These categories include, *inter alia*, debts: for alimony, maintenance or child support (523(a)(5)); for willful or malicious injury (523(a)(6)); for death or personal injury caused by operation of a motor vehicle while intoxicated (523(a)(9)); and as provided in federal criminal restitution orders (523(a)(13)).

b. *Procedures for showing nondischargeability.* The Bankruptcy Code defines "debt" broadly, to include any liability on a "claim." 11 U.S.C. § 101(12). A "claim" can be, among other things: (a) an unliquidated and disputed right to payment; (b) a right to payment that has been reduced to a judgment after litigation; or (c) a right to payment under the terms of a settlement agreement, *id.* § 101(5). A "debt" can take any of these, or many other, forms.

When a debt is both "unliquidated" and "disputed," a creditor who contends that the debt is nondischargeable must show two things. *First*, the creditor must prove that "by rules of state law" it is entitled to payment (in bankruptcy parlance, that the claim is "allowed"). *See id.* §§ 501, 502 (set-

ting forth procedures for filing "proofs of claims" and resolving objections thereto); *Grogan*, 498 U.S. at 283 (describing "the standard of proof that a creditor must satisfy in order to establish a valid claim against a bankrupt estate"). *Second*, through an "adversary proceeding" to determine nondischargeability, the creditor must prove that the debt falls within one of the categories of nondischargeability set forth in Section 523(a) of the Bankruptcy Code. *See* 4 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 523.06, at 523-21 to 523-22 (15th rev. ed. 2002). Only the second demonstration—that the debt is nondischargeable—requires the creditor to initiate an adversary proceeding by filing a complaint in bankruptcy court. *See* Fed. R. Bankr. P. 4007, 7001-7087.[1]

If the debt takes the form of a judgment entered after a matter has been litigated, either party may invoke principles of collateral estoppel, in the adversary proceeding, to establish that the debt either does or does not fit within a category of nondischargeability set out in Section 523(a). For example, if the judgment entailed proof of fraud, the debtor will be estopped from denying, in the nondischargeability action, that the underlying debt was for money obtained by fraud. *Grogan*, 498 U.S. at 284. Collateral estoppel could also run in favor of the debtor, if a claim for fraud was previously litigated and judgment entered in the debtor's favor.

If the judgment is silent on whether the underlying claim arose from fraud, the creditor would be required to prove, in the nondischargeability proceeding, that the debt is traceable to fraud. Principles of res judicata do not constrain the creditor in this proof. *Brown v. Felsen*, 442 U.S. 127, 135 (1979).

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[1] The bankruptcy court has exclusive jurisdiction over determinations of nondischargeability for certain categories of debt (those set forth in Section 523(a)(2), (4), (6) and (15)). 11 U.S.C. § 523(c)(1); *Brown v. Felsen*, 442 U.S. 127, 135-36 (1979). For other categories of debt, jurisdiction may be exercised either by the bankruptcy court or any other state or federal court of competent jurisdiction. 4 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 523.03, at 523-17 (15th rev. ed. 2002).

To the contrary, the creditor may introduce evidence relating to the underlying debt itself in order to demonstrate that the debt is in fact nondischargeable. *See id.*

The question presented in this case is whether the same principles should apply in cases in which the litigation ended in a settlement.

2. Factual Background And Proceedings Below.

a. According to the nondischargeability complaint filed in bankruptcy court (J.A. 86-90),[2] Leonard L. Warner and Respondent Arlene Warner bought a light manufacturing company for $250,000. (J.A. 47.) They then altered the company's financial records so that the financial statements would suggest that the company was very profitable (making more than $360,000 per year in profits), when in fact it was losing money. (J.A. 36-47.) The Warners then offered the company for resale for $1.24 million. Six months after buying the company, in May 1992, the Warners resold it to a corporation formed by Petitioners A. Elliott and Carol Archer. Based on the falsified financial records as well as other false statements made to them by the Warners, stating that the underlying business was a profitable one, the Archers

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[2] The nondischargeability complaint incorporates the allegations in an amended complaint previously filed in the state court fraud action, J.A. 34-60. As set forth below, *infra* at 8, the bankruptcy court, pursuant to Fed. R. Bankr. P. 7016 and Fed. R. Civ. P. 16(c), severed the question whether the settlement of the state court fraud suit barred the nondischargeability action from the question whether the underlying allegations of fraud were true. (J.A. 129-130.) Having found in favor of Respondent on the affirmative defense that the settlement barred the nondischargeability action, the bankruptcy court did not address the allegations of fraud. For purposes of appeal, those allegations must therefore be taken as true. *Cf. Swierkiewicz v. Sorema*, 534 U.S. 506 (2002) (assuming factual allegations to be true on reviewing dismissal of complaint).

agreed to pay $610,000 for the assets of the company. (*Id.*; Pet. App. 30a.)[3]

Upon taking possession of the assets, the Archers discovered that the financial statements provided to them by the Warners, and other representations the Warners made in connection with the sale, were materially false, and that the business was in fact losing substantial sums of money. (J.A. 36-47.) The Archers accordingly brought suit in late 1992 against Leonard Warner in state court in North Carolina asserting various claims, including common law fraud. On September 20, 1993, a grand jury indicted Leonard Warner for "misrepresent[ing] the financial condition of Greensboro Awning Company, Greensboro Fence Company and A&A Fence Company in negotiating for the sale of these companies to Archer." (J.A. 32-33.) Arlene Warner was added as a defendant in the civil action in 1994. (J.A. 34-60.)

After discovery, the parties (on the eve of trial) entered into a settlement agreement on May 11, 1995, under which the Archers would receive $300,000, consisting of a $200,000 cash payment and a promissory note for $100,000 payable in two installments over a year.[4] In connection with the settlement, the parties agreed to execute a settlement agreement (J.A. 61-66), a general release (J.A. 67-69), a mutual release (J.A. 70-72), and the promissory note (J.A. 73-76), secured by a deed of trust. In the settlement agreement, the Archers agreed "to inform the District Attorney that they

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[3] The Archers also paid a $70,000 consulting fee to Leonard Warner, and $5,000 in consideration for a non-compete agreement from Leonard Warner, bringing the total consideration in the transaction to $685,000. (Pet. App. 30a.)

[4] Although the promissory note was secured by two deeds of trust, one on a home that the Warners owned and one on real property owned by Hosiery Industries, Inc., another corporation owned by the Warners, all of those assets were subject to prior liens, and therefore did not adequately secure the $100,000 in indebtedness. (*See* J.A. 75.)

have been compensated for their loss." (J.A. 62.) The district attorney accordingly dismissed the indictment. (J.A. 77-79.) The settlement agreement also provided that the releases being executed would not release any claims "as to amounts set forth in this Settlement Agreement." (J.A. 63.)

The general release stated that, in consideration for the payment of $300,000, the Archers "release and forever discharge [the Warners] from any and every right, claim or demand which [the Archers] now have or might otherwise hereafter have against [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of [the state court litigation]." (J.A. 67.) Consistent with the settlement agreement, the general release expressly excluded from the release "obligations under a Note and deeds of trust executed contemporaneously herewith." (*Id.*) No party "admit[ted] liability or wrongdoing whatsoever in signing this agreement." (*Id.*) A separate document, entitled a "mutual release," was executed contemporaneously, and included similar release language. (J.A. 70.)

The Warners defaulted on the first payment due on the promissory note, which was due on November 11, 1995. (J.A. 87.) The Archers thereupon brought a collection suit in state court in North Carolina to recover on account of the debt due to them on the note, arising from the underlying fraud allegations. (J.A. 88.)

b. On February 6, 1996—while the state court collection action was pending and less than nine months after entering into the settlement under which the Warners wrote the promissory note—Leonard and Arlene Warner filed for relief under chapter 13 of the Bankruptcy Code. (Pet. App. 31a.) Their case was subsequently converted to chapter 7. (*Id.*) The Archers thereupon brought an adversary proceeding in the bankruptcy case against the Warners, seeking a determination that the debt was nondischargeable on the ground, inter *alia*, that it was for money obtained by fraud. 11 U.S.C.

§ 523(a)(2).[5] Leonard Warner did not contest the issue of dischargeability in bankruptcy court, which entered a consent judgment against him. (Pet. App. 39a-41a.)

Arlene Warner did contest dischargeability, asserting that the underlying debt was not obtained on account of any fraud on her part, and that the settlement of the fraud claim barred the Archers from relying on any underlying acts of fraud in support of the claim of nondischargeability. (J.A. 91-94.) The bankruptcy court bifurcated the proceedings, first addressing the "affirmative defense" that the general release given in connection with the settlement of the state court fraud suit barred the nondischargeability action in the bankruptcy court. (J.A. 129-130.)

Following decisions of the Seventh and Ninth Circuits, the bankruptcy court concluded that the release barred the Archers from attempting to prove nondischargeability. "By including in the release future claims, the court concludes that the plaintiffs effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant." (Pet. App. 35a.)[6]

The district court affirmed, agreeing that inquiry into the nature of the underlying debt was prohibited because that debt had been settled and a general release signed. (Pet. App. 20a-25a.)

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5 The Archers subsequently sought to amend their complaint to allege that the settlement agreement was procured by means of fraud. (J.A. 95-108.) The bankruptcy court denied the motion for leave to amend the complaint on grounds of procedural default. (J.A. 109.) While the Archers do not challenge that determination in this Court, the surrounding circumstances are set forth in the Affidavit of Harry G. Gordon at J.A. 124-126.

6 Because a consent judgment had been entered against Leonard Warner, the bankruptcy court's final disposition of the claims against Arlene Warner represented a final judgment (Pet. App. 39a), appealable to the district court under 28 U.S.C. § 158(a)(1).

c. A divided panel of the court of appeals affirmed. The panel majority ruled that, by settling, the Archers relinquished not only their right to sue on the underlying fraud, but also compromised their ability to collect the amount promised in the settlement. In the court's view, the settlement effected a "novation" that converted the nondischargeable fraud claim into a dischargeable contract claim. (Pet. App. 8a-10a.) The court believed that its approach was necessary to promote settlement: "Under this theory, parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise the incentive to settle is gone." (Pet. App. 8a.)

Judge Traxler dissented, urging that the contrary approach taken by the D.C. and Eleventh Circuits better serves the underlying congressional judgment that certain debts should not be discharged in bankruptcy. He explained that "'a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress . . . , merely by altering the *form* of his debt through a settlement agreement.'" (Pet. App. 12a (quoting *United States v. Spicer*, 57 F.3d 1152, 1156 (D.C. Cir. 1995) (alteration in original).) "[I]f, as the Supreme Court has declared, 'the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt' . . . then I see no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry." (Pet. App. 15a (quoting *Brown*, 442 U.S. at 138).)

SUMMARY OF ARGUMENT

An animating purpose of federal bankruptcy law is to provide honest but unfortunate debtors with a fresh start. Accordingly, at the end of a debtor's bankruptcy case, the debtor's dischargeable prepetition debts are discharged, and

creditors are thereby enjoined from taking any action to collect such debts. *See* 11 U.S.C. § 524.

The "fresh start" is available only to "honest but unfortunate debtors," not those whose debts arise, for instance, on account of fraud or embezzlement. Section 523(a) of the Bankruptcy Code accordingly sets forth 18 exceptions to the discharge. A creditor who contends that the debt owed to him or her is nondischargeable because it falls within one of the categories specified in Section 523(a) may bring an action in the bankruptcy court seeking a declaration to that effect.

The Fourth Circuit below held that if the debt is reduced to a settlement agreement, the creditor is barred from asserting that it is nondischargeable. The court's rationale was that the settlement effected a "novation," under which the debt reflected in the settlement agreement replaced the debt arising on account of the alleged acts of fraud.

While it may be true that a settlement effects a novation, it does not follow that the "new" debt is dischargeable. To the contrary, this Court's decision in *Brown*, 442 U.S. 127, makes clear that the bankruptcy court must nevertheless undertake an inquiry into whether the "new" debt is traceable to fraud.

Under ordinary principles of res judicata, once a judgment is entered, the plaintiff is barred from suing on the underlying claim, and is permitted only to bring suit to enforce the judgment. The judgment effects a "novation" no differently from the way in which a settlement does. That fact notwithstanding, *Brown* held that in a nondischargeability action, the bankruptcy court should "weigh all the evidence" to determine whether the debt "aris[es] out of conduct specified [in Section 523(a)], because "Congress intended the fullest possible inquiry" into whether the underlying source of the debt was an act of fraud." *Brown*, 442 U.S. at 138.

The fundamental holding of *Brown* is that, despite the finality afforded to judgments, the bankruptcy court should nevertheless undertake a fresh examination into the question whether the underlying debt is nondischargeable. That holding accords with this Court's conclusions that the plain meaning of the Bankruptcy Code—which provides that "any debt" for money obtained by fraud is nondischargeable—demonstrates an intent to exclude from the discharge any debt "resulting from" or "traceable to" fraud, in order to effectuate the policy of limiting the discharge to the honest but unfortunate debtor. *Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998). The same principle applies with equal force to debts reduced to settlements.

The court of appeals believed that its approach was necessary to promote settlement. While it is true that a rule that would render dischargeable otherwise nondischargeable debt would give the *debtor* an added incentive to settle, it would have a simultaneous and opposite effect on the creditor's incentives. Insofar as the rule would encourage settlements at all, then, it would do so in circumstances in which an unwitting creditor was unaware of the debtor's financial condition or the effect the settlement would have on a claim of nondischargeability. There is no reason to read Section 523(a) of the Bankruptcy Code to create such a trap for the unwary.

There is certainly nothing in the Archers' settlement agreement itself, a standard settlement with a general release, that requires this result. The settlement agreement here, like any standard settlement, preserves all rights the creditor might have to enforce his rights to collect the amount the debtor promised to pay under that settlement. The assertion that the debt is nondischargeable is no more than an effort to collect that amount.

In any event, even if the parties had intended to resolve, at the time the state court suit was settled, the question of dischargeability, there is serious question as to whether such an agreement would be unenforceable as inconsistent with—

and therefore preempted by—fundamental principles of bankruptcy law. In the context of bankruptcy, an agreement between the debtor and creditor regarding the settlement of a dispute affects not only the debtor and creditor, but also all third-party creditors, whose claims will be paid out of the same limited pool of the debtor's assets.

The discharge confers a personal benefit on an individual debtor. Thus, a rational debtor would always be willing to promise to pay more to a creditor in connection with a settlement that rendered dischargeable an otherwise nondischargeable debt than the debtor would offer to settle the same dispute in the absence of such a feature. In the event of bankruptcy, then, the creditor would enter the bankruptcy case with a proportionately larger claim against the assets available to pay unsecured creditors, thereby diluting the claim of other unsecured creditors. As a result, the debtor benefits, and other unsecured creditors are harmed.

The Bankruptcy Code contains specific provisions that serve to guard against this risk. Specifically, once a bankruptcy case has begun, any disposition of the debtor's property, including any settlement or compromise of any dispute, requires approval of the bankruptcy court, on notice to creditors. *See* 11 U.S.C. § 363; Fed. R. Bankr. P. 9019. Enforcing a prepetition agreement addressing questions of dischargeability—which arise only in the bankruptcy context—would permit an end run around these protections that the Bankruptcy Code affords all creditors.

Because the debtor benefits from the discharge, but does not suffer any corresponding detriment by these actions that dilute the recovery of other creditors, permitting the parties to negotiate, prepetition, over questions of nondischargeability permits the debtor to "externalize" the costs while "internalizing" the benefits. The Bankruptcy Code should not be construed to permit a debtor, in effect, to purchase a discharge of otherwise nondischargeable debt using money that properly belongs to other creditors.

ARGUMENT

I. THE FORM OF A DEBT IS IRRELEVANT TO THE QUESTION OF DISCHARGEABILITY.

Under the Bankruptcy Code, "any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud" is exempt from discharge. 11 U.S.C. § 523(a)(2)(A). This Court has repeatedly stressed the breadth of this exception, explaining that it encompasses all debt "resulting from" or "traceable to" fraud. *Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998) (quoting *Field v. Mans*, 516 U.S. 59, 61, 64 (1995)).

Thus, in *Cohen*, the Court held that the exemption includes an entire treble damages award rendered on account of fraud, and is not limited to the debtor's ill-gotten gains. The Court explained, by using the broad phrase "*any* debt," Congress intended to except from discharge any "debt as a result of," "debt with respect to," "debt by reason of," "debt arising from," or "debt on account of," an act of fraud. *Cohen*, 523 U.S. at 220. In short, the issue boils down to a basic question of causation—if a causal connection can be drawn between the debt and an act of fraud, the debt is nondischargeable.

This conclusion follows directly from the text of the Bankruptcy Code. A "debt," for the purposes of bankruptcy law, can take any number of different forms. The Bankruptcy Code defines a "debt" to mean any "liability on a claim," 11 U.S.C. § 101(12), and in turn defines the term "claim" to include a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," *id.* § 101(5).[7]

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[7] The intentional breadth of the definition of "debt," and thus the significance of the fact that "any debt" traceable to fraud is nondischargeable, is confirmed by the history of Section 523, whose antecedent is Sec-

In the language of the Bankruptcy Code, then, when a creditor who was a victim of fraud settles the fraud claim with the tortfeasor, the form of the debt is converted from being "unliquidated" and "disputed," to being "liquidated" and "undisputed." Although the form of the debt has changed, there can be no question that it remains a debt that is "traceable to" fraud. *Cohen*, 523 U.S. at 218. As the D.C. Circuit explained, while a "settlement agreement alters the legal form of [an] obligation, it does not transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy." *United States v. Spicer*, 57 F.3d 1152, 1157 (D.C. Cir. 1995) (Wald, J.).

This result is unsurprising, because a debtor who defrauds a creditor and then settles is no more honest than a debtor who defrauds a creditor and then loses at trial. To deny the creditor who settles the chance to prove that his debt arose from fraud would thus be at odds with Congress's judgment that only the "honest but unfortunate" debtor deserves a fresh start. *Cohen*, 523 U.S. at 217 (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)).

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tion 17 of the Bankruptcy Act of 1898. As originally enacted, the Bankruptcy Act provided that only "judgments" for fraud would be excepted from the discharge. 30 Stat. 550. This provision was amended in 1903 to provide that all "liabilities" for fraud would be excepted from the discharge, regardless of whether those "liabilities" were in the form of a "judgment." *See also Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 562 (1990) ("Congress defined 'debt' broadly and took care to except particular debts from discharge where policy considerations so warranted."); H.R. Rep. No. 95-595, at 309 (1977) (definition of "claim" is "broadest possible").

II. SETTLEMENT OF A CLAIM DOES NOT BAR A CREDITOR FROM PROVING THAT THE OBLIGATION TO PAY ON THE SETTLEMENT IS NONDISCHARGEABLE.

The parties to a matter that has been litigated to judgment may invoke collateral estoppel to show that the debt is, or is not, nondischargeable. *Grogan*, 498 U.S. at 284-85. The collateral estoppel doctrine is not available, of course, in a case that has been settled.[8] Rather, the creditor is required to prove that his debt arose from fraud. There is nothing in the nature of a settlement, however, that is inconsistent with allowing a creditor to present such proof. To the contrary, it follows from this Court's decision in *Brown* that a creditor should be allowed to establish the connection between the debt and an underlying act of fraud.

A. In *Brown*, the owner of a car dealership was alleged to have induced a third-party, by making false statements, to guarantee a bank loan. When the dealership failed to pay, the bank brought a collection action in state court against the dealership, its owner and the guarantor. The guarantor cross-claimed against the dealership owner, claiming that the guarantee was fraudulently obtained. *Brown*, 442 U.S. at 128.

The state court action ended in a settlement. In connection with that settlement, the state court entered a consent judgment, authorizing the bank to recover jointly and severally against the dealership owner and the guarantor and allowing the guarantor to recover against the dealership owner.

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[8] "To support preclusion at all, there must be a judgment in some form; a settlement agreement by itself is effective only as a contract." 18A Charles Alan Wright et al., *Federal Practice and Procedure* § 4443, at 255-56 (2d ed. 2002). Because collateral estoppel applies only to a matter that has been "actually litigated," settlements may be entitled to claim preclusive (res judicata) effect, but do not support issue preclusion (collateral estoppel). *See Arizona v. California*, 530 U.S. 392, 414 (2000); *United States v. International Building Co.*, 345 U.S. 502, 505-06 (1953).

Neither the judgment nor the stipulation indicated the cause of action on which the judgment was entered, or otherwise addressed whether acts of fraud were or were not committed. *Id.* The dealership owner failed to pay on the stipulated judgment, and shortly thereafter filed for bankruptcy. *Id.*

This Court rejected the argument that principles of res judicata barred the guarantor, in a nondischargeability proceeding, from proving facts that he could have established but did not in the underlying suit. *See id.* at 138. Rather, the Court held that it was incumbent on the bankruptcy court, as a matter of federal bankruptcy law, to "weigh all the evidence" to determine whether the debt arose out of fraud. "Congress intended the fullest possible inquiry" into that question. *Id.* As the Court explained, "the mere fact that a conscientious creditor has previously reduced his claim to judgment" did not "bar further inquiry into the true nature of the debt" or prevent the bankruptcy court from making "an accurate determination whether respondent in fact committed the deceit, fraud and malicious conversion which petitioner alleges." *Id.*[9] (*see also* J.A. 14a) (Traxler, J., dissenting) ("In deciding cases dealing with the fraud exceptions to dischargeability, courts should effectuate congressional policy objectives by conducting the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor.")).

B. The principal basis for the court of appeals' ruling in this case was that a settlement effects a "novation," by which it meant "the substitution of a contract claim for a tort claim through a settlement agreement . . . ." (Pet. App. 9a n.8.) But this characterization of the debt does not distin-

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[9] While *Brown* involved Section 17 of the Bankruptcy Act of 1898, the predecessor to Section 523(a) of the Bankruptcy Code, the *Brown* Court expressly noted that "[d]ischarge provisions substantially similar to § 17 of the Bankruptcy Act appear in § 523 of the new law." *Brown*, 442 U.S. at 129 n.1.

guish this case from *Brown*. To the contrary, precisely the same could have been said in *Brown*—that the judgment replaced the underlying claim of fraud. That fact notwithstanding, this Court held that the bankruptcy court should make a factual inquiry into whether the debt was traceable to fraud and thus, nondischargeable. The same is true here.

The consequence of a novation is simply that the creditor may no longer sue on the underlying fraud, but must sue on the note. *See Black's Law Dictionary* 1091 (7th ed. 1999) (defining "novation" to be the "act of substituting for an old obligation a new one that . . . replaces an existing obligation with a new obligation"). A judgment creditor is likewise barred from suing on the underlying claim, and may sue only to enforce the judgment. Thus, the fact of a "novation" does not distinguish a settlement from a judgment. Once a claim is litigated to judgment, the claim "is extinguished, and the judgment with new rights of enforcement thereof is substituted for the claim." *See* Restatement (Second) of Judgments § 17 (1982) cmt. a. A judgment therefore represents a "novation" in every sense.

Brown established that a bankruptcy court hearing a nondischargeability action should nevertheless seek to determine whether the "new" debt arising from the judgment can be traced to an act of fraud. There is no reason to treat a "novation" by settlement differently from a "novation" by judgment.[10] In both cases, the debtor owes a "debt" within

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[10] The leading bankruptcy treatise describes this as "the better view" in addressing Section 553 of the Bankruptcy Code. Under that provision, a creditor may offset amounts its owes to the debtor from amounts the debtor owes to it, provided that the obligations in both directions are characterized as prepetition debts. *See* 5 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 553.03[1][ii], at 553-24 (15th rev. ed. 2002) (pointing to *Spicer*, *West*, and other lower court cases on nondischargeability in support of conclusion that "the better view is that a prepetition claim should not be transformed into a postpetition obligation simply because the parties settled rather than litigated").

the meaning of the Bankruptcy Code, and that debt is nondischargeable so long as it is "resulting from" or "traceable to" fraud. *Cohen*, 523 U.S. at 218.

C. Indeed, *Brown* itself involved a dispute that was settled. As the Court noted, the state court action "was settled by a stipulation" and the state court entered a "consent judgment." 442 U.S. at 128, 132.

While a consent judgment is entered by a court, it is, in substance, a settlement agreement. Consent judgments are "contractual in nature, and are, in effect, contracts or agreements of parties acknowledged in court and ordered to be recorded with the sanction of the court." 46 Am. Jur. 2d *Judgments* § 210, at 535 (1994); *see also id.* at 537 ("A consent decree is essentially a settlement agreement subject to continued judicial policing.") And, like an out-of-court settlement, a consent judgment "do[es] not result from a judicial determination of the rights of the parties or the merits of the case." *Id.* at 535. There is thus no plausible basis for distinguishing between these forms of settlement in determining whether a nondischargeability action may proceed. *See In re Francis*, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998) (creditor should not be "barred from the opportunity to prove the true nature of the debt just because the parties elected to keep their settlement agreement private and not to burden the state court with an unnecessary consent judgment").

For purposes of determining whether a debt is dischargeable, there is no reason to treat an obligation that is reflected in a settlement agreement any differently from an obligation that has been reduced to judgment. Indeed, the central purpose of a settlement agreement containing a release is to create the same finality afforded to a final judgment by virtue of the doctrine of res judicata.

In general, "an undisputed and valid settlement of a controversy by agreement of the parties has the same force and effect as though a judgment had been entered in an action on

the claim, and irrevocably fixes the rights and liabilities of the parties thereto in relation to the subject matter dealt with." 15A C.J.S. *Compromise & Settlement* § 26 (1967).

Accordingly, courts generally grant settlement agreements the same claim preclusive (res judicata) force as are given to judgments. In *Oglesby v. Attrill*, 105 U.S. 605 (1881), for example, this Court enforced a compromise agreement releasing fraud claims, stating that the "compromise stands, therefore, *as a judgment*, making a settlement of the very matters now set up as grounds of complaint in the petition . . . ." *Id.* at 611 (emphasis added).[11]

There is therefore no basis for drawing a decisive distinction, as the court of appeals has, between a settlement agreement reflected in a consent judgment, and a settlement agreement whose terms are documented in a private contract. In either case, questions relating to the dischargeability of the debt remain "the type of question Congress intended that the bankruptcy court would resolve" after "the fullest possible inquiry." *Brown*, 442 U.S. at 138.

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[11] *See Thomas v. Louisiana*, 534 F.2d 613, 615 (5th Cir. 1976) ("Settlement agreements . . . [w]hen fairly arrived at and properly entered into . . . are generally viewed as binding, final, and as conclusive of rights as a judgment"); *A.D. Juilliard & Co. v. Johnson*, 259 F.2d 837, 844 (2d Cir. 1958) ("The effect of a compromise and settlement effected by parties competent to contract is that of a judgment which can only be set aside in a direct proceeding."); *Crisp County v. S.J. Groves & Sons Co.*, 73 F.2d 327, 329 (5th Cir. 1934) ("This settlement was . . . not different in this respect from a judgment on it, if there had been litigation instead of a compromise."). *See also Arizona v. California*, 530 U.S. 392, 414 (2000) ("the settlement indeed had, and was intended to have, claim-preclusive effect") (emphasis omitted); *Hoxworth v. Blinder*, 74 F.3d 205, 208 (10th Cir. 1996) ("Generally, court-approved settlements receive the same *res judicata* effect as litigated judgments.").

III. NOTHING ABOUT THE ARCHERS' SETTLEMENT IN PARTICULAR SUGGESTS AN INTENT TO WAIVE THEIR RIGHT TO ESTABLISH NONDISCHARGEABILITY.

A. As just explained, there is nothing about settlement in general that prevents a creditor from attempting to establish that the underlying debt arose from fraud. Nor is there anything in the Archers' settlement in particular that would suggest an intent to waive the right to establish the nondischargeability of their debt.

1. The general release that the Archers signed stated that, in consideration for the payment of $300,000, they "release and forever discharge [the Warners] from any and every right, claim or demand which [the Archers] now have or might otherwise hereafter have against [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of [the state court litigation]." (J.A. 67.) The agreement expressly excluded from the release, however, "obligations under a Note and deeds of trust executed contemporaneously herewith." (*Id.*; *see also* J.A. 63 ("All parties to the litigation agree to execute releases to any and all claims any party may have or may have had against the other in any way arising out of this litigation, except as to amounts set forth in this Settlement Agreement.").)[12]

Thus, far from impairing their right to collect on the note, the settlement agreement that the Archers signed expressly preserved that right. Indeed, even without this express reservation, a settlement agreement releasing an underlying claim in exchange for a promise to pay an agreed

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12 A separate document, entitled a "mutual release," was executed contemporaneously, and inciuded similar release language. (J.A. 70.) The general release (J.A. 67) and settlement agreement (J.A. 62) expressly note that the underlying claims arise out of allegations of fraud and other intentional torts.

amount certainly does not to waive the right to collect the amount promised under that agreement.

2. Because the nondischargeability action was brought solely in order to enforce the agreement to pay that amount, the agreement does not waive the right to show nondischargeability. As this Court explained in *Brown*, a nondischargeability action is not an affirmative "claim" against the debtor at all. The creditor "does not assert a new ground for recovery." *Brown*, 442 U.S. at 133. Rather, the creditor "is attempting to meet . . . the new defense of bankruptcy which [the debtor] has interposed between [the creditor] and the sum determined to be due to him." *Id.*[13]

This case is illustrative. After the Warners defaulted on the promissory note, the Archers brought a collection action in order to enforce their right to recover the $100,000 due to them. That action was subject to the automatic stay in bankruptcy, and the Archers were thus precluded from taking any action to prosecute their collection suit during the pendency of the bankruptcy case. *See* 11 U.S.C. § 362(a). While the automatic stay ends at the end of the bankruptcy case, *see id.* § 362(c)(2), a debtor thereafter may assert the discharge as a defense to the collection action, *see id.* § 524.

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13 Indeed, until 1970, questions of dischargeability of debt were commonly heard in state court as a defense to an action to collect on that debt. *See, e.g.*, *Local Loan Co. v. Hunt*, 292 U.S. 234, 241 (1934) (stating that state court "was authorized in the law action to afford relief the equivalent of that which respondent now seeks in equity"). "Before 1970, . . . [bankruptcy courts] left the dischargeability under § 17 of a particular debt to the court in which the creditor sued, after bankruptcy, to enforce his particular judgment." *Brown*, 442 U.S. at 133. "The 1970 amendments took jurisdiction over certain dischargeability exceptions, including the exceptions for fraud, away from the state courts and vested jurisdiction exclusively in the bankruptcy courts." *Grogan*, 498 U.S. at 284 n.10; *see* Pub. L. No. 91-467, §§ 5-7, 84 Stat. 992; H.R. Rep. No. 91-1502 (1970); S. Rep. No. 91-1173 (1970). Accordingly, bankruptcy courts are the proper forum for resolving this "new defense of bankruptcy." *Brown*, 442 U.S. at 133.

Thus, even if it were not expressly excluded from the release because it is an action to collect on the note received under the settlement, the Archers' nondischargeability action still would not be released because it is not a "right, claim or demand" within the meaning of the settlement agreement. The Archers do not assert any new ground for recovery or seek to recover any additional amount beyond enforcing their rights under the settlement agreement and promissory note. Rather, the nondischargeability action is a response to the "new defense of bankruptcy," *Brown*, 442 U.S. at 139, that would otherwise bar their state court collection suit brought on the promissory note.

B. The court of appeals nonetheless believed that, to encourage settlement, it was justified in treating this agreement as waiving the right to show nondischargeability. According to the court of appeals, "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract. Otherwise, the incentive to settle is gone." (Pet. App. 8a.)

While it is true that *debtors* who may discharge their debts when they settle otherwise nondischargeable claims have an additional incentive to settle before trial, creditors are simultaneously and equally discouraged from settling. Because the consent of both parties is of course required for a matter to settle, there is no reason at all to believe that a legal rule that made settlement more attractive to a debtor, but (to the same extent) less attractive to creditors, would increase the likelihood of settlement. To the contrary, as in *Brown*, the rule applied by the court of appeals would require a creditor to litigate the issue of fraud "to the hilt in order to protect himself against the mere possibility that a debtor might take bankruptcy in the future." *Brown*, 442 U.S. at 135.

The only circumstances in which the rule applied by the Fourth Circuit below would change the likelihood of settlement, then, would be those in which a plaintiff is unaware that the defendant is likely to file for bankruptcy, or is not

alert to the legal effect of entering into a settlement agreement that is silent on the question of nondischargeability. In those cases, a plaintiff who enters into a standard settlement agreement will have unwittingly agreed to have an otherwise nondischargeable debt converted into a claim that will be discharged in bankruptcy. Those defendants who are likely to file for bankruptcy—and who of course have greater access to information about their own financial condition than their creditors—would therefore be able to circumvent the effect of Section 523(a) of the Bankruptcy Code by settling claims for otherwise nondischargeable debt with creditors who are unaware of those consequences.

There is no warrant to construe the Bankruptcy Code—which seeks to promote fairness among creditors—to create such a trap for the unwary. Indeed, in light of the fact that many of Section 523(a)'s provisions are intended for the benefit of creditors who may be most in need of protection (such as those who have been victims of fraud, 11 U.S.C. § 523(a)(2) & (a)(4); victims of "willful and malicious injury by the debtor," *id.* § 523(a)(6); and creditors who are owed awards of alimony, maintenance or child support, *id.* § 523(a)(5)), it would be particularly inappropriate to adopt a construction of the statute that effectively creates an incentive for an unscrupulous debtor to take advantage of an unwitting creditor.[14]

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[14] The trap for the unwary created by the court of appeals' construction of Section 523(a) is further demonstrated by the fact that an astute creditor would be able to take steps to protect itself, in negotiating a settlement agreement, to prevent the debt from being rendered dischargeable. For example, the settlement agreement might be structured such that the creditor grants a covenant not to sue on the underlying fraud claim, conditioned on timely payment of the agreed amount, rather than granting a release of the underlying claim. (*See also* Pet. App. 24a (district court opinion suggesting other such steps).) In any event, it is clear that the potential availability of such measures does not provide a basis for concluding, in their absence, that the settlement agreement renders the debt dischargeable. *See Brown*, 442 U.S. at 137 (rejecting the argument

IV. A PREPETITION WAIVER OF NONDISCHARGEABILITY PROTECTIONS SHOULD, IN ANY EVENT, BE DEEMED NONENFORCEABLE.

Even if the settlement agreement had purported to waive the Archers' right to establish the nondischargeability of their debt, there would be a serious question whether such a provision could be enforced. As explained below, a prepetition waiver of nondischargeability rights would impair the rights of other creditors, who are not parties to the agreement. Such a provision thus would be inconsistent with federal bankruptcy policy.

Bankruptcy law is a set of mandatory rules, designed to protect debtors and to provide for the fair treatment among creditors in circumstances in which the debtor's insolvency renders it impossible for all creditors to be paid in full.[15] Such rules frequently override the contractual agreements of debtors and creditors.

For example, in order to protect debtors, the Bankruptcy Code expressly provides that a postpetition agreement in which a debtor agrees to "reaffirm" a debt that would otherwise be dischargeable cannot be enforced unless specified

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that the debt was dischargeable because "petitioner could have avoided such a result and preserved his dischargeability contentions for bankruptcy court review by bargaining for a stipulation that § 17 issues were not resolved by the consent judgment").

[15] *See, e.g.*, Teresa A. Sullivan et al., *As We Forgive Our Debtors* 20 (1999) (describing the interest in "[p]rotecting each creditor from other creditors to achieve the fairest collective result" as one of bankruptcy's "most fundamental policies"); Peter J. Coleman, *Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy, 1607-1900*, at 269-70 (1999) (describing purpose of "American bankruptcy system" as being to "put all creditors on an equitable footing"); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 Yale L.J. 437, 468 (1992) ("The Code is thus designed not only to enhance the value of the failing business, but also to distribute that value among interested parties in specified ways.").

statutory requirements (intended to protect debtors) are met. 11 U.S.C. § 524(c); *see In re Bennett*, --- F.3d ---, 2002 WL 1784136, at *5-6 (9th Cir. Aug. 5, 2002). Courts and commentators agree that *pre*petition agreements that a debt will not be discharged cannot otherwise be enforced. *See, e.g., In re Kroen*, 280 B.R. 349, 352-53 (Bankr. D.N.J. 2002) (citing cases); *In re Cole*, 226 B.R. 647, 651-52 & nn.6 & 7 (B.A.P. 9th Cir. 1998) (collecting cases); *see also* Douglas G. Baird, *The Elements of Bankruptcy* 34-36 (rev. ed. 1993) (describing nonwaivability of fresh start); Thomas H. Jackson, *The Fresh-Start Policy In Bankruptcy Law*, 98 Harv. L. Rev. 1393 (1985) (same).

In addition to protecting debtors from overreaching by creditors, the Bankruptcy Code also promotes fair treatment among creditors. In a chapter 7 liquidation, assets that were property of the debtor are marshaled for the benefit of the creditors. In these circumstances the risk is necessarily present that the debtor and any single creditor might reach an agreement that serves each of their interests at the expense of other creditors. The laws of preference (*see* 11 U.S.C. § 547) and fraudulent conveyance (*see id.* § 548), for example, are intended to address these concerns. Thus, bankruptcy law and policy commonly require courts to invalidate such contractual agreements on the ground that they impermissibly burden the rights of absent third-party creditors.[16]

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[16] For example, a voluntary prepetition agreement between a debtor and a creditor to waive the protection of the automatic stay cannot be enforced in bankruptcy. *See, e.g., Ostano Commerzanstalt v. Telewide Sys., Inc.*, 790 F.2d 206, 207 (2d Cir. 1986) (per curiam) ("Since the purpose of the stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay."); *Association of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446, 448 (3d Cir. 1982) (stating in dictum that a debtor cannot waive stay protection); *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) (stating in dictum that advance agreements to waive the benefits of bankruptcy are void); *In re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) (concluding that "the prebankruptcy waiver of the automatic stay of 11 U.S.C. § 362 is unenforce-

That is the concern that counsels against the enforcement of an agreement, made outside of bankruptcy, to provide that an otherwise nondischargeable debt would become dischargeable. The nondischargeability of a debt is a personal detriment to the debtor; it does not affect the rights of his or her creditors (other than the one to whom the debt is owed).

As the Seventh Circuit acknowledged, "[a] tort-feasor may well be inclined to pay an aggrieved party a larger sum in settlement if the settlement [renders the claim dischargeable]." *In re West*, 22 F.3d 775, 778 (7th Cir. 1994). But if the debtor "purchases" a discharge by paying a creditor more than he otherwise would pay to settle the claim, he secures a personal benefit by effectively diluting the claims that other creditors would otherwise have in the bankruptcy case. Such an agreement would permit a debtor to "externalize" the costs (by imposing them on other creditors) while "internalizing" the benefits (by enjoying the discharge after bankruptcy).[17] It thus should be deemed unenforceable as a matter of law as inconsistent with the Bankruptcy Code. *See In*

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able, per se"); *In re Jenkins Court Assocs.*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) (refusing to enforce a prepetition waiver of the automatic stay); *In re Sky Group Int'l Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) (same). Enforcing such an agreement "may prejudice [other creditors] by permitting the [creditor] to recover first from the debtor's assets. . . . The idea that parties can override bankruptcy law by contract . . . therefore conflicts with the traditional view that bankruptcy law is a form of public law, imposing mandatory rules to preserve distributional and rehabilitative interests." Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515, 519-20 (1999).

17 *Cf.* G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 Bus. L. 499, 554 (2000) ("Because creditors have the right to exhaust the value of the debtor's nonexempt property through the enforcement of their claims, any further diminution in the value of the debtor's property arising from the debtor's risk taking will necessarily reduce the value of the creditor's stake--generating an 'externality' with respect to their creditors."); *see generally* Ronald H. Coase, *The Firm, the Market, and the Law* 24 (1990).

re Francis, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998) (holding that Section 523(a) of the Bankruptcy Code "trumps any state release law . . . that might otherwise apply in favor of the debtor"); *Spicer*, 57 F.3d at 1156 ("whether or not" a settlement contains "an express release" providing that the debt is dischargeable, "a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress in § 523(a)(2)(A)").[18]

Indeed, this Court has suggested that issues of dischargeability should not be resolved outside the purview of the bankruptcy court, which would be required to approve any settlement reached during bankruptcy "after notice and a hearing." Fed. R. Bankr. P. 9019. Specifically, *Brown* noted that "[i]f a state court should expressly rule on § 17 questions, then giving finality to those rulings would undercut Congress' intention to commit § 17 issues to the jurisdiction of the bankruptcy court," rather than allow "prebankruptcy state-court adjudications." *Brown*, 442 U.S. at 135-36.

* * * * *

In sum, this Court's decision in *Cohen* makes clear that a debt traceable to fraud is nondischargeable, and *Brown* holds that the fact that a stipulated judgment stands between the fraud and the debt does not prevent a bankruptcy court from inquiring into whether the debt is in fact traceable to the fraud. Nothing in the settlement agreement here purports to change this result, nor, as a matter of bankruptcy law, could it. Accordingly, the task of the bankruptcy court is clear—to allow a creditor a chance to prove that its debt is for money obtained by means of fraud, and therefore nondischargeable.

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18 The law of fraudulent conveyance would not provide sufficient protection against this risk, because a creditor may defeat a fraudulent conveyance challenge merely by showing that he personally received "approximately equivalent" or "roughly equivalent" value. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 538 n.4 (1994).

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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QUESTIONS PRESENTED

1. Whether creditors are precluded from asserting that a debt represented by a promissory note arises from fraud and is nondischargeable under 11 U.S.C. § 523(a)(2)(A), when the note was given in settlement of a prior state-court litigation, and that settlement was incorporated into a final judgment on the merits that is, under state law, collateral estoppel against the creditors on the precise fraud issue to be asserted under Section 523(a)(2)(A).

2. Whether 11 U.S.C. § 523(a)(2)(A) permits creditors to assert that a promissory note debt is nondischargeable because it arises from fraud, when the note was received as consideration in a contractual settlement of disputed litigation in which the creditors expressly released, and agreed never to reassert, the very allegations of fraud on which the nondischargeability claim rests.

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BRIEF FOR RESPONDENT

STATEMENT

This case poses the question whether Section 523(a)(2)(A) of the Bankruptcy Code, which excepts debts based on fraud from discharge in bankruptcy, overrides the usual power of litigants — including creditors — to release and forswear the later assertion of disputed claims, including claims of fraud, in order to reach a settlement acceptable to both sides. Petitioners contend that various policy concerns in bankruptcy require a departure from the usual rule that a party is free to relinquish his own claims. As a result, they argue that no pre-bankruptcy settlement — however explicit it may be in disposing of the issue of fraud — may ever foreclose assertion of fraud in order to establish that the settlement debt is excepted from discharge under Section 523(a)(2)(A).

On the facts of this case, this contention flies directly in the teeth of this Court's clear precedent. The parties' state-court settlement and categorical release of the fraud claim was incorporated into a judgment on the merits by way of a voluntary dismissal with prejudice. Under governing North Carolina law, the judgment thus entered is binding as collateral estoppel against any future fraud allegations encompassed within those issues resolved by the North Carolina court. Because this Court has held explicitly that collateral-estoppel principles bind bankruptcy courts, specifically in determinations of issues under Section 523(a), the bankruptcy court must give the same preclusive effect to the state-court judgment that the rendering North Carolina court itself would give.

While collateral estoppel plainly compels the outcome here, this case should be resolved under a broader rule. Given that bankruptcy courts must follow state law of collateral estoppel insofar as it renders a state-court settlement judgment binding on the issue of fraud, no compelling reason appears why bankruptcy courts should not also be bound by contractual

settlements that are enforceable under state law. Plainly, the viability of the settlement process depends on the capacity of litigants to enter into binding contracts. Where, as here, a settlement contract is enforceable under state law and has the effect of preventing one party from resurrecting a particular allegation (because it has been expressly released for all time), that contract should be given effect in bankruptcy, barring some provision of the Code directing a contrary conclusion. No such contravening Code provision exists here, even though Congress has expressly provided, with regard to two other narrow categories of claims, that settlement contracts will not be enforced as to render a debt dischargeable. And just as there is no contravening statutory language, none of the bankruptcy policy arguments offered by petitioners supports denying the parties' settlement its obvious contractual effect of foreclosing any further allegation of fraud.

* * *

In the spring of 1992, petitioners Elliott and Carol Archer negotiated with respondent's husband, Leonard Warner, to purchase the assets of Warner Manufacturing, Inc. J.A. 36-41. On May 22, 1992, Leonard Warner and his son, Stuart Warner, entered into an agreement on behalf of Warner Manufacturing to sell the company's assets for $685,000 to a corporation formed by petitioners. Pet. App. 2a; J.A. 41.

In late 1992, petitioners filed a complaint in the Superior Court of Guilford County, North Carolina, alleging misconduct in connection with the sale and naming as defendants only Leonard Warner and Warner Manufacturing. Pet. App. 2a; J.A. 100. Around the same time, and based upon the same alleged conduct, the State of North Carolina indicted Leonard Warner on a charge of obtaining property by false pretenses. J.A. 32-33. Over a year later, on March 2, 1994, petitioners amended their complaint to add respondent Arlene Warner as a defendant. But petitioners confined their allegations concerning respondent to conclusory statements contained in a single paragraph of the complaint and did not

assert any specific acts by her in connection with the sale transaction. J.A. 46, ¶ 39.

The amended complaint contained counts alleging breach of contract, fraud and misrepresentation, conspiracy, piercing the corporate veil, fraudulent conveyance, statutory unfair or deceptive trade practices, and constructive trust. J.A. 47-58. The parties to the state-court action conducted extensive pre-trial discovery and negotiations. On May 11, 1995, the parties, all represented by counsel, settled the litigation. J.A. 61. They executed a "Settlement Agreement," J.A. 61-66, and two separate releases, which they characterized as a "General Release" and a "Mutual Release." J.A. 67-72.

The Settlement Agreement stated that petitioners' willingness to settle was motivated by, among other things, the "numerous defenses asserted by the defendants." J.A. 62. It provided further that payment was intended "as compensation for emotional distress/personal injury type damages," J.A. 61, petitioners having amended their complaint three days before settlement to include claims for intentional and negligent infliction of emotional distress. Pet. App. 2a. "Leonard L. Warner or one or more of the other defendants" had to give petitioners a $200,000 certified check and a $100,000 promissory note secured by a second lien on specific property owned by Leonard and Arlene Warner. J.A. 61-62, 73-76. The entire settlement was expressly conditioned upon dismissal of the pending criminal action against Leonard Warner. J.A. 63, 77.

In consideration of the Warners' commitment, and the immediate delivery of a payment of $200,000 and a conforming note and deeds of trust, petitioners executed a "General Release," stating that they:

> hereby release and forever discharge [the Warners] from any and every right, claim, or demand which [petitioners] now have or might otherwise hereafter have against the [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of the

> litigation in Guilford County Superior Court . . . excepting only obligations under a Note and deeds of trust executed contemporaneously herewith.

J.A. 67. The General Release acknowledged that the state-court defendants "expressly denied" any liability. J.A. 68.

The parties to the state-court action also executed a Mutual Release, "cumulative" with the General Release, in which they recited that the settlement was "the compromise of disputed claims" carrying no admission of liability, "all such liability being expressly denied." J.A. 70, 71. As the name suggests, in the Mutual Release the parties released each other

> from any and every right, claim, or demand . . . from the beginning of the world to the date of this release, particularly including, but not limited to, all claims, demands and causes of action in the Lawsuit and all claims, demands and causes of action that could have been asserted therein, excepting only obligations under a Promissory Note and Mortgages executed simultaneously or near simultaneously herewith.

J.A. 70-71. The Mutual Release further provided that "[t]he terms of the two releases [General and Mutual] are contractual in nature and not mere recitals" and that each party signed the "release . . . willingly and voluntarily and with full knowledge of all facts and other matters relevant to the Lawsuit." J.A. 71.

The Settlement Agreement expressly provided that the parties would not "avoid or attempt to avoid the legal obligation to consummate the settlement of this litigation on the above terms and [would execute a] dismissal with prejudice of the litigation." J.A. 63. The Mutual Release similarly provided that the "Lawsuit and all claims therein will be dismissed with prejudice by the plaintiffs forthwith." J.A. 71.

On May 15, 1995, petitioners filed their notice of voluntary dismissal of the state-court litigation "with prejudice." J.A.

80-81. Under North Carolina law, this dismissal operated as a final judgment on the merits that resolved all claims in the complaint against the petitioners. *See Miller Bldg. Corp. v. NBBJ North Carolina, Inc.*, 497 S.E.2d 433, 435 (N.C. Ct. App. 1998); *Bailey v. Gitt*, 518 S.E.2d 794, 795 (N.C. Ct. App. 1999). *See* pp. 15-20 *infra*.

The Warners defaulted on a note payment due November 11, 1995. On December 4, 1995, petitioners sued in state court for "collection on the note," making no allegations of fraud or other claims raised in the original litigation. Pet. App. 3a. While that suit was pending, on February 5, 1996, the Warners filed a petition for relief under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the Middle District of North Carolina, which was later converted to a Chapter 7 proceeding. *Id.*

In March 1996, petitioners filed a proof of claim in the bankruptcy court for $122,480.13, an amount comprising the principal, interest, and attorneys' fees alleged to be owing under the terms of the note. J.A. 82-84. Ten months later, petitioners filed an adversary proceeding in the bankruptcy court alleging that this claim was nondischargeable under Section 523(a)(2)(A) of the Bankruptcy Code, which they supported only by incorporating the allegations of the amended state-court complaint. J.A. 88; Pet. App. 4a.

In response to that nondischargeability claim, on May 27, 1997, Leonard Weaver signed a "consent order" that reaffirmed the debt and authorized entry of a bankruptcy-court order "declaring that defendant Leonard L. Warner's debt to plaintiffs is nondischargeable." Pet. App. 39a, 41a. Respondent, however, answered the nondischargeability claim and asserted that the "$100,000.00 debt to the [petitioners] arising [from] the settlement of Guilford County Civil Action 92 CVS 777 . . . did not arise from any fraud, . . . so as to be a non-dischargeable debt under 11 U.S.C. Section 523(a)(2)." J.A. 93-94.

On June 25, 1998, petitioners moved to amend their Section 523(a) complaint to set forth, for the first time, specific actions allegedly taken by respondent, *see* J.A. 97-100, and to contend, also for the first time, that the Warners had "fraudulently induced" petitioners to accept the note as part of a settlement "with no present intention to pay the same." J.A. 104-05. The bankruptcy court denied the motion to amend because petitioners' attorney did not appear on the date the motion was to be heard. Pet. App. 4a-5a n.4; J.A. 109. On May 27, 1999, nearly eleven months later, petitioners renewed their motion to amend, but the bankruptcy court again denied the motion for reasons that do not appear on the record. Pet. App. 4a-5a n.4; J.A. 111, 127. Petitioners do not challenge these rulings in this Court. Pet. Br. 8 n.5.

On August 26, 1999, the bankruptcy court held a hearing and ruled that the debt on the note was dischargeable. Pet. App. 29a. The court held that the allegations of fraud "were included in the settlement" entered into by the parties, Pet. App. 32a, and that there is "nothing in § 523(a) which can be read as making it unlawful or illegal for a [creditor] alleging fraud to enter into a settlement under which [the creditor] agrees to release any claim which might arise in the future under § 523." Pet. App. 34a. Here, the court reasoned, petitioners executed a "broad" release "after [they] and their counsel had the benefit of extensive information developed through prolonged discovery." Pet. App. 35a. In view of that fact, and the facts that petitioners had "received the cash payment of $200,000.00 as well as the promissory note and deeds of trust, [petitioners] may not now raise the dischargeability claim they now assert based upon the same allegations and claims contained in the complaint in their original action." *Id.* "[T]he only misconduct alleged in this action is the same misconduct described in the original complaint which plaintiffs dismissed with prejudice pursuant to the settlement." *Id.*

The district court affirmed, stating that the "bankruptcy court correctly concluded that the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy." Pet. App. 21a. The "settlement agreement contained a complete release," and "[t]here is absolutely nothing about federal bankruptcy law that should disturb that state law outcome." Pet. App. 22a, 23a. "[N]othing in the Bankruptcy Code interrupts the ordinary capacity of creditors under nonbankruptcy law to contract for the release of claims that are or might be nondischargeable in bankruptcy." Pet. App. 24a (quotation omitted).

The district court noted specifically that "there are several reliable ways to ensure that a debt for fraud does not become dischargeable in bankruptcy after the parties settle the claim." The creditor can make "the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement, . . . make the debtor acknowledge that any release of liability is conditional until full payment is made," and/or require that the settlement agreement "be subject to plaintiff's right to assert non-dischargeability in a bankruptcy proceeding." Pet. App. 24a.

The Fourth Circuit affirmed the district court, agreeing with decisions of two other circuits holding that "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy." Pet. App. 8a. The court found no evidence of congressional intent "to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a)." *Id.* Here, the "settlement package . . . announced the complete waiver of all pending and future related personal claims against Arlene Warner." Pet. App. 9a. Because the "settlement agreement and promissory note here, coupled with the broad language of the release, completely addressed and released each and every underlying state law claim" including

fraud, the Fourth Circuit held that petitioners had relinquished their right to assert fraud as a basis for nondischargeability under Section 523(a). Pet. App. 10a.

Judge Traxler dissented, endorsing a line of circuit cases that he said best effectuated Congress's policy favoring "the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor." Pet. App. 14a. Judge Traxler stated that a debtor could "completely immunize himself from § 523 by simply settling any fraud claims against him with a promise to pay, having the plaintiff release the underlying tort action as part of the settlement, and then filing for bankruptcy." *Id.*

SUMMARY OF ARGUMENT

This Court's clear precedents and ordinary principles of collateral estoppel compel affirmance of the decision below. This Court has held that collateral estoppel applies in Section 523(a) discharge proceedings, and, under the Full Faith and Credit Statute, federal courts — including bankruptcy courts — must give the same preclusive effect to state-court judgments that those state courts would give them. Here, petitioners and respondent executed a settlement agreement and categorical release of petitioners' fraud (and other) allegations. Petitioners then filed a voluntary dismissal of their state action with prejudice, which, under North Carolina law of collateral estoppel, operated as a judgment on the merits that resolved all contentions in the complaint against the petitioners. Petitioners' theory of fraud in the state-court litigation is identical to the theory of fraud pleaded in their Section 523(a) complaint. Furthermore, the elements of fraud under North Carolina law and under Section 523(a) are identical, as are the burdens of proof imposed upon the complainant. Thus, under this Court's clear precedent and the governing collateral-estoppel law of North Carolina, petitioners' allegations of fraud have been determined on the merits, and petitioners are foreclosed from asserting fraud as a ground for nondischargeability under Section 523(a).

Although this case can be resolved by the straightforward application of collateral-estoppel principles, it should be resolved on broader grounds. Where parties form a valid, enforceable contract in which they stipulate to facts or relinquish certain claims in order to achieve settlement, bankruptcy courts should limit the parties to asserting whatever rights remain to them under that settlement contract. A creditor's property rights against the bankruptcy estate are defined by state law. Here, the law of North Carolina recognizes a valid contract whereby the parties have entered into a novation, creating a new promissory note and relinquishing all right to assert pre-existing claims, including the allegation of fraud contained in the prior complaint. Granting petitioners rights that they have expressly waived by contract would inject uncertainty into the binding effect of settlement agreements. Such a result finds no justification under the Bankruptcy Code or its attendant policies.

Promoting settlements of litigation is an important policy throughout our judicial system, but especially so in bankruptcy. Settlements in bankruptcy, including settlements of nondischargeability claims, play a crucial role in promoting judicial efficiency and maximizing debtor resources available to pay creditors. These same benefits flow from enforcing pre-bankruptcy settlements of the type at issue here. Any rule that would allow a creditor to resurrect earlier released claims of fraud would, to say the least, be disruptive of such settlements, and should not be endorsed absent compelling statutory grounds.

No such grounds can be found or derived from the language of the Bankruptcy Code. To the contrary, Section 523(a) itself contains two provisions in which Congress has expressly determined that settlements of specific types of claims can never render a debt dischargeable. Congress's express inclusion of such a restriction in other subsections of Section 523(a) cannot be squared with petitioners' contention that it should be included by inference in Section 523(a)(2).

Nor do petitioners' policy arguments provide a reason for refusing to enforce pre-bankruptcy settlement agreements in which a creditor agrees not to assert issues of fraud against a debtor. *First*, bankruptcy's policy of limiting the right of discharge to the "honest but unfortunate debtor" is not offended when, as here, the parties have expressly confronted the issue of fraud, resolved their differences, and agreed that the issue of fraud will not be raised again. On such facts, courts should accept the parties' conclusion that the claim of fraud is either wholly without merit or unworthy of pursuit, recognizing that the Code contains separate, explicit provisions for denying discharge to debtors who engage in egregious acts of fraud injurious to the interests of creditors and the bankruptcy process. *Second*, there is nothing tricky or treacherous in a rule that bankruptcy courts honor settlement agreements as they are written. Parties have a broad range of options as to the terms of their settlements, and it is their job (and that of their lawyers) to secure a settlement that will have the binding — or non-binding — effects they desire. *Finally*, petitioners' concern that a debtor may, to render them dischargeable, settle fraud claims for more than they are worth, thus allowing the claiming creditor to receive more than his fair share from the bankruptcy estate, is a hypothetical one of little practical moment. Further, as petitioners admit, this concern is already addressed by the Code's preferential transfer and fraudulent conveyance provisions.

ARGUMENT

I. PRINCIPLES OF COLLATERAL ESTOPPEL AND FEDERALISM COMPEL THE DECISION BELOW FORECLOSING THE ASSERTION OF FRAUD AS A BASIS FOR FINDING THE NOTE NONDISCHARGEABLE UNDER 11 U.S.C. § 523(a)(2)(A)

Collateral estoppel is an essential principle of American jurisprudence by which propositions of fact or law, once raised and necessarily decided by a final judgment on the

merits, become binding as between the same parties in all future disputes. *See, e.g.*, Restatement (Second) of Judgments § 27 (1982). This Court has made clear that this fundamental principle applies in the context of bankruptcy, so that prior judgments reached outside of bankruptcy will determine factual and legal issues that become relevant in bankruptcy. *See Grogan v. Garner*, 498 U.S. 279, 284 n.11 (1991) (collateral estoppel applies to determinations of dischargeability issues under Section 523(a)).[1] It is also clear under the Full Faith and Credit Statute, 28 U.S.C. § 1738, that federal courts, including bankruptcy courts, must give the same collateral-estoppel effect to prior state-court judgments that courts of that state would give them. On the facts of this case and under applicable North Carolina law, petitioners are collaterally estopped from asserting their claim that the debt for the outstanding note is nondischargeable under Section 523(a)(2). Accordingly, this Court should affirm the decision below.

A. The Parties' Settlement Resulted In A Final Judgment On The Merits That, Under The Governing North Carolina Law of Collateral Estoppel, Is Preclusive Against Petitioners On The Issue Of Fraud

1. Bankruptcy Courts Must Give State-Court Judgments The Same Preclusive Effect They Would Have Under That State's Law

Where the appropriate prerequisites for collateral estoppel are satisfied, the determination of "an issue of fact or law" in a prior litigation is "conclusive in a subsequent action between the parties on the same or a different claim." Restatement (Second) of Judgments § 27. Not only is this principle

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[1] *See also, e.g., In re Spigel*, 260 F.3d 27, 33 (1st Cir. 2001) (collateral estoppel applies in bankruptcy proceedings generally); *In re Cochrane*, 124 F.3d 978, 983 (8th Cir. 1997) (same); *In re Bulic*, 997 F.2d 299, 303 (7th Cir. 1993) (same).

generally applicable in bankruptcy, but in *Grogan* this Court "clarif[ied] that collateral estoppel principles do indeed apply in discharge proceedings pursuant to § 523(a)." 498 U.S. at 284 n.11, *see also Brown v. Felsen,* 442 U.S. 127, 139 n.10 (1979). Indeed, petitioners and the United States agree that a debtor "may invoke collateral estoppel to show that the debt is, or is not, nondischargeable." Pet. Br. at 15; *see* United States *Amicus* Br. at 20 n.3.

The Full Faith and Credit Statute, 28 U.S.C. § 1738, "requires federal courts to give the same preclusive effect to state court judgments that those judgments would be given in the courts of the State from which the judgments emerged." *Kremer v. Chem. Constr. Corp.*, 456 U.S. 461, 466 (1982). Thus, a "federal court [must] look first to state preclusion law in determining the preclusive effects of a state court judgment." *Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 381 (1985). If state preclusion law would bar relitigation of an issue, the federal court must accord the state judgment the same preclusive effect in a subsequent federal litigation "unless some exception to § 1738 applie[s]." *Id.*; *accord Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 375 (1996).

An exception to Section 1738 "will not be recognized unless a later statute contains an express or implied partial repeal" of that statute. *Kremer*, 456 U.S. at 468 (internal quotation marks omitted). The Bankruptcy Code contains no express repeal of Section 1738 as it pertains in the context of Section 523(a)(2). And this Court has "seldom, if ever, held that a federal statute impliedly repealed § 1738." *Matsushita*, 516 U.S. at 380. "[R]epeals by implication are not favored," *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 154 (1976) (internal quotation omitted), and any implied repeal of Section 1738 must rest on the "clear and manifest" intent of Congress. *Matsushita*, 516 U.S. at 380. Such intent might be shown by an "irreconcilable conflict" between Section 1738 and a later statute, or by the fact that a later statute "covers the whole

subject of the earlier one and is clearly intended as a substitute." *Kremer*, 456 U.S. at 468 (internal quotation marks omitted). Neither type of conflict arises in the case of the Bankruptcy Code.

In particular, "[n]o evidence of Congressional intent to create an exception to Section 1738 for dischargeability cases can be found in either the Bankruptcy Code or its legislative history." 18 *Moore's Federal Practice* § 132.03[2][k][iii][A] (3d ed. 1997). The fact that Congress placed the determination of nondischargeability issues within the exclusive jurisdiction of the bankruptcy courts does not support any such conclusion. As this Court made clear in *Matsushita*, exclusive federal jurisdiction over issues is not, in itself, a barrier to applying state preclusion law as commanded by Section 1738. 516 U.S. at 381-82 (exclusive federal securities law jurisdiction no basis for an exception); *accord Marrese*, 470 U.S. at 380 (exclusive federal antitrust jurisdiction no basis for an exception). This is so even though the application of state collateral-estoppel law may in practical terms be "'conclusive upon the [federal] question in issue.'" *Matsushita*, 516 U.S. at 384 (quoting *Becher v. Contoure Labs., Inc.*, 279 U.S. 388, 391 (1929)). Indeed, the Court in *Matsushita* cited *Brown v. Felsen*, 442 U.S. at 139 n.10, which noted that collateral-estoppel principles could establish that state-court litigation decided the issue of fraud against a creditor, as accepting this possibility. 516 U.S. at 384.

Thus, the application of state collateral-estoppel law is consistent with the grant of exclusive jurisdiction to the bankruptcy court to determine nondischargeability. Section 1738 merely requires a bankruptcy court to determine that question while giving due preclusive effect to prior litigation of common-law fraud (which is the same as fraud under

Section 523(a)(2), *see Field v. Mans*, 516 U.S. 59, 70 (1995)) in state-court proceedings.[2]

Finally, *Matsushita* held that application of state-law collateral estoppel is proper even if, as here, the relevant state-court judgment is entered pursuant to a settlement between the parties. *Matsushita* involved a judgment based on a settlement of state-court litigation and held that Section 1738 "mandate[s] full faith and credit of state court judgments incorporating global settlements, provided the rendering court had jurisdiction over the underlying suit itself." 516 U.S. at 385. As with the Securities and Exchange Act at issue in *Matsushita*, there is no suggestion in the Bankruptcy Code that "Congress meant for plaintiffs . . . to have more than one day in court" to establish a fraud claim. *Id.* at 381.

Accordingly, every federal court of appeals to consider this issue has held that state collateral-estoppel law applies when determining the preclusive effect of a state judgment in a

[2] Nor is partial repeal of Section 1738 suggested by the purposes motivating Congress's grant of exclusive jurisdiction to bankruptcy courts to address dischargeability issues. The "primary purpose" for granting exclusive jurisdiction to the bankruptcy court was to protect unrepresented debtors against abuse by creditors seeking nondischargeability orders in *post*-bankruptcy, state-court actions. *Brown*, 442 U.S. at 135-36. Certainly this objective is not offended by affording the usual collateral-estoppel effect to *pre*-bankruptcy state-court settlement judgments foreclosing creditor claims. The "secondary purpose" of concentrating nondischargeability decisions was to allow bankruptcy courts to "develop expertise" in handling such issues. *Id.* Likewise, this objective is wholly consistent with adherence to the usual principles of collateral estoppel and federalism. *See Matsushita*, 516 U.S. at 384.

nondischargeability proceeding.[3] Leading commentators agree that this is the correct result.[4]

2. The North Carolina Settlement Resulted In A Judgment On The Merits That Is Preclusive Against Petitioners On The Issue Of Fraud, As Fraud Is Defined In 11 U.S.C. § 523(a)(2)(A)

Under North Carolina law, a "final judgment on the merits prevents relitigation of issues actually litigated and necessary to the outcome of the prior action in a later suit involving a different cause of action between the parties." *Thomas M. McInnis & Assocs., Inc. v. Hall*, 349 S.E.2d 552, 557 (N.C. 1986) (citing Restatement (Second) of Judgments § 27). Thus, a party who invokes collateral estoppel must show that "the earlier suit resulted in a final judgment on the merits, that the issue in question was identical to an issue actually litigated and necessary to the judgment, and that [both parties to the present case] were either parties to the earlier suit or were in privity with parties." *Id.*

The parties to the Section 523(a) nondischargeability proceeding were all parties to the North Carolina litigation.

[3] *See In re Spigel*, 260 F.3d 27, 33 (1st Cir. 2001); *In re Bogdanovich*, 292 F.3d 104, 110 (2d Cir. 2002); *In re Brown*, 951 F.2d 564, 568-69 (3d Cir. 1991); *In re McNallen*, 62 F.3d 619, 624 (4th Cir. 1995); *In re Caton*, 157 F.3d 1026, 1027 (5th Cir. 1998); *In re Calvert*, 105 F.3d 315, 317 (6th Cir. 1997); *In re Bulic*, 997 F.2d 299, 304 n.6 (7th Cir. 1993); *In re Madsen*, 195 F.3d 988, 989 (8th Cir. 1999); *In re Harmon*, 250 F.3d 1240, 1245 (9th Cir. 2001); *In re Laing*, 945 F.2d 354, 358 (10th Cir. 1991); *In re St. Laurent*, 991 F.2d 672, 675-76 (11th Cir. 1993).

[4] *See, e.g.*, 18B C. Wright, *et al.*, *Federal Practice & Procedure* § 4470.3 (2d ed. 2002) ("The exclusive bankruptcy jurisdiction does not imply repeal [of Section 1738]."); W. Norton, *Norton Bankruptcy Law and Practice* § 47:72 (2d ed. 2002) ("The better view is to apply the same collateral estoppel effect to a judgment as would the court issuing the judgment."); C. Tabb, *The Law of Bankruptcy* § 1.14, at 60 (1997) ("State law is important [in nondischargeability proceedings] because a bankruptcy will give collateral estoppel effect to litigation in state court.").

Furthermore, there is no question that the North Carolina suit ended in a final judgment on the merits on the issue of fraud, which was actually litigated in that action and necessarily decided against petitioners by the judgment. Under North Carolina law, where a "plaintiff file[s] a Stipulation of Dismissal with Prejudice," that action "constitutes a final judgment on the merits" which "'preclude[s] subsequent litigation to the same extent as if the action had been prosecuted to a final adjudication adverse to the plaintiff.'" *Miller Bldg. Corp. v. NBBJ North Carolina, Inc.*, 497 S.E.2d 433, 434-35 (N.C. Ct. App. 1998); (quoting *Barnes v. McGee*, 204 S.E.2d 203, 205 (N.C. Ct. App. 1974)); *accord Bailey v. Gitt*, 518 S.E.2d 794, 795 (N.C. Ct. App. 1999); *Caswell Realty Assocs. v. Andrews Co.*, 496 S.E.2d 607, 611 (N.C. Ct. App. 1998).

This is so even "'if the rendering court made no express findings on issues raised by the pleadings or the evidence'" because "'the court may infer that in the prior action a determination appropriate to the judgment rendered was made as to each issue that was so raised.'" *Miller Bldg.*, 497 S.E.2d at 435 (quoting 18 *Moore's Federal Practice* § 132.03 [4][i] (3d ed. 1997)). "[T]he dismissal 'with prejudice' . . . therefore constitutes an adjudication of those issues against the plaintiff," and a subsequent court must find that identical issues raised in the second action "are barred by collateral estoppel." *Miller Bldg.*, 497 S.E.2d at 435; *see also Caswell Realty*, 496 S.E.2d at 611 ("voluntary dismissal with prejudice" combined with "sufficient identification" of issues "call[s] the doctrine of res judicata and/or collateral estoppel into play"); *NationsBank of North Carolina v. Am. Doubloon Corp.*, 481 S.E.2d 387, 393 (N.C. Ct. App. 1997) (consent judgment is a final judgment that carries collateral estoppel effect); *Nash Cty. Bd. of Educ. v. Biltmore Co.*, 640 F.2d 484, 486-87 (4th Cir. 1981) (same; applying N.C. law).

Thus, it is true in North Carolina, as under the decisions of this Court, that a final judgment based on an express

stipulation of fact, or, as here, an express relinquishment of claims with prejudice, satisfies the "actually litigated" prerequisite to collateral estoppel. *See Matsushita*, 516 U.S. at 385-86. Otherwise, parties could never finally resolve disputed issues without an actual judicial fact finding, a result that would be at odds with common sense and the long-standing rule that "a judgment entered by confession, consent, or default . . . may be conclusive . . . with respect to one or more issues, if the parties have entered an agreement manifesting such an intention." Restatement (Second) of Judgments § 27 cmt. e. *See also* 18 *Moore's Federal Practice* §§ 132.03[2][h][i], [2][k][ii] (stipulations and consent judgments carry collateral-estoppel effect if the parties so intend); F. James, *Consent Judgments as Collateral Estoppel*, 108 U. Pa. L. Rev. 173, 188 (1959) (same).[5]

The only basis on which to avoid this conclusion under North Carolina law is by showing that a party "was denied an opportunity to litigate these issues in the first case." *Miller Bldg.*, 497 S.E.2d at 435. But no such showing can be made here. Petitioners' action proceeded in Guilford County Superior Court for almost three years. The parties conducted substantial discovery and engaged in lengthy settlement negotiations. Those negotiations culminated in a settlement agreement and two releases, the import of which was to

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[5] Federal courts, in a variety of contexts, repeatedly have applied this rule and assigned collateral-estoppel effect to stipulations and settlements where the parties intended such a result. This intent is evidenced by a discharge and general release with prejudice of all claims. *See, e.g., In re Berr*, 172 B.R. 299, 304 (B.A.P. 9th Cir. 1994); *Foster v. Hallco Mfg. Co.*, 947 F.2d 469, 480-81 (Fed. Cir. 1991); *Barber v. Int'l Bhd. of Boilermakers*, 778 F.2d 750, 757-58 (11th Cir. 1985); *Green v. Ancora-Citronelle Corp.*, 577 F.2d 1380, 1383 (9th Cir. 1978); *Yachts Am., Inc. v. United States*, 673 F.2d 356, 361-63 (Ct. Cl. 1982). This Court has acknowledged the rule in other cases, but, on the particular facts of those cases, found no evidence that the parties intended their settlement to carry preclusive effect. *See Arizona v. California*, 530 U.S. 392, 414 (2000); *Lawlor v. Nat'l Screen Serv. Corp.*, 349 U.S. 322, 327 & n.12 (1955); *United States v. Int'l Bldg. Co.*, 345 U.S. 502, 505-06 (1953).

release all rights, including the right to assert fraud against respondent, in exchange for delivery of $200,000 in cash and a secured note for $100,000. The agreements expressly provided that plaintiffs would "dismiss the complaint with prejudice . . . forthwith," J.A. 63, 71, thus evidencing an unmistakable intention to finally resolve the fraud issues in a binding manner. *Cf. Cudmore v. Howell*, 232 B.R. 335, 338-40 (E.D.N.C. 1999) (under North Carolina law, default fraud judgment against debtor carried collateral-estoppel effect in Section 523(a) nondischargeability proceeding where debtor filed an answer, engaged in settlement negotiations, and had a full and fair opportunity to litigate his claims in state court).

Nor is there any question that the theory of fraud pleaded in petitioners' nondischargeability complaint is identical to the theory of fraud pleaded — and finally resolved — in the North Carolina action. As the court below expressly noted, petitioners' bankruptcy-court pleading offered as grounds for nondischargeability only the allegations contained in the North Carolina complaint, which were simply incorporated by reference. Pet. App. 4a.

Moreover, both the elements of fraud and the burden of proof required of a fraud plaintiff under North Carolina law are identical to those required of a creditor under Section 523(a)(2)(A). In North Carolina, the elements of a fraud claim track the standard elements of fraud set forth in the Restatement (Second) of Torts. *See, e.g., Rowan Cty. Bd. of Educ. v. United States Gypsum Co.*, 407 S.E.2d 860, 863 (N.C. Ct. App. 1991). *See also Cofield v. Griffin*, 78 S.E.2d 131, 134 (N.C. 1953) (applying same elements of fraud from Restatement (First) of Torts). Specifically, a North Carolina fraud claim requires a "misrepresentation" made with "knowledge of its falsity" and with "intention" that it be relied upon, a party's "reasonable" reliance, and injury. *Horack v. S. Real Estate Co. of Charlotte, Inc.*, 563 S.E.2d 47, 53 (N.C. Ct. App. 2002); *Becker v. Graber Builders, Inc.*, 561 S.E.2d 905, 910 (N.C. Ct. App. 2002).

Likewise, fraud under Section 523(a)(2)(A) "incorporate[s] the general common law of torts." *Field*, 516 U.S. 59 at 70 n.9 (1995). Specifically, the Court in *Field* referenced the Restatement (Second) of Torts as the "most widely accepted distillation of the common law of torts." *Id.* at 70. The Restatement defines fraud as a "misrepresentation" that the maker "knows" is false, "intention . . . of inducing another to act," "justifiable reliance" upon the misrepresentation, and injury. Restatement (Second) of Torts §§ 525, 526. And this Court emphasized in *Field* that, even though the reliance element in fraud claims under North Carolina law is often stated as "reasonable reliance," it is, in its application, the same as the "justifiable reliance" standard applied under Section 523(a)(2)(A). 516 U.S. at 73-74 & n.12 (citing *Johnson v. Owens*, 140 S.E.2d 311, 314 (N.C. 1965)).[6]

Finally, a fraud plaintiff's burden of proof under North Carolina law is identical to the creditor's burden under Section 523(a)(2). Under North Carolina law, a plaintiff bears the burden of proving fraud "not beyond a reasonable doubt, nor even by clear and convincing proof, but by a preponderance of the testimony and to the satisfaction of the jury." *Dare Cty. v. Smith Const. Co.*, 67 S.E. 37, 38 (N.C. 1910); *accord, e.g., Hodges v. Wilson*, 81 S.E. 340, 343 (N.C. 1914). Section 523(a) likewise requires "the creditor to establish by a preponderance of the evidence that his claim is not dischargeable" because it is based on a debt obtained by fraud. *Grogan*, 498 U.S. at 287.

Accordingly, the parties' settlement resolution of this case, evidencing a clear intention to foreclose future assertions of

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[6] *See also Marcus Bros. Textiles, Inc. v. Price Waterhouse, LLP*, 513 S.E.2d 320, 327 (N.C. 1999) (the "question of justifiable reliance is analogous to that of reasonable reliance in fraud actions") (internal quotation marks omitted); *Rowan Cty. Bd. of Educ.*, 407 S.E.2d at 863 ("Recovery in fraud also requires justifiable reliance by the plaintiff in acting or refraining from action because of the defendant's fraudulent misrepresentation.").

fraud against respondent, and embodied in a final judgment of the North Carolina court, carries collateral-estoppel effect in North Carolina as to the claims and issues thus finally resolved. The fraud claim resolved in North Carolina is identical to the fraud claim asserted in the bankruptcy court, and this Court's cases mandate that North Carolina's law of collateral estoppel governs. As a result, petitioners may not assert fraud as a ground for nondischargeability under Section 523(a).

B. This Conclusion Is Fully Consistent With This Court's Decision In *Brown v. Felsen*, Which Held That *Res Judicata* Does Not Foreclose Contentions Supporting Claims Of Nondischargeability That Might Have Been Resolved In A Prior Proceeding, But Were Not

Applying collateral estoppel to prevent petitioners from relitigating their fraud claims is entirely consistent with *Brown v. Felsen*, 442 U.S. 127 (1979). There, the debtor and creditor had reached a stipulated settlement of litigation, incorporated into a consent judgment, that specified the amount owed by the debtor to the creditor, but omitted any statement of the legal theory on which that money was agreed to be owing. When the debtor declared bankruptcy, the creditor filed a claim of nondischargeability on the ground that the agreed amount of the debt arose from fraud by the debtor. The debtor argued that this assertion was barred by *res judicata*.

This "res judicata claim [was] unlike those customarily entertained by the courts." 442 U.S. at 132. The debtor argued that the consent judgment, though favorable to the creditor and fully consistent with the claim that the debtor had committed fraud, nonetheless foreclosed the creditor from asserting fraud under Section 523(a) because the judgment did not finally determine that the debtor had, in fact, committed fraud. *Id.* at 134. Under the debtor's view, the earlier state court proceeding was "the appropriate forum for resolving all

debtor-creditor disputes, including those concerning dischargeability." *Id.*

This Court rejected this *res judicata* argument because it would have forced creditors litigating claims in state court "to try [nondischargeability] questions to the hilt in order to protect [themselves] against the mere possibility that a debtor might take bankruptcy in the future," even if the creditor could win his state-court claim without ever resolving those issues. 442 U.S. at 135. Any such result "would undercut Congress' intention to commit [nondischargeability] issues to the jurisdiction of the bankruptcy court." *Id.* The Court thus refused to "resolve a federal dischargeability question according to whether or not the parties in state court waived their right to engage in hypothetical litigation in an inappropriate forum." *Id.* at 137.

In contrast, petitioners here are attacking a prior state-court judgment and settlement that, under the collateral-estoppel law of North Carolina, resolved all issues of fraud against them. *Brown* itself expressly distinguished between its refusal to recognize *res judicata* as foreclosing all theories that might have been raised in the prior proceeding (but were not), and "collateral estoppel [which] treats as final only those questions actually and necessarily decided in a prior suit." 442 U.S. at 139 n.10. *Brown* allowed for the possibility that collateral estoppel might apply to nondischargeability issues. *Id.* In *Grogan*, the Court held expressly that it does. 498 U.S. at 284 n.11.

Nor is there any incongruity between *Brown* and *Grogan*. Where a prior judgment is collateral estoppel on the issue of fraud, that issue necessarily has been confronted by the parties and resolved on the merits, based on either a factfinding or an agreement of the parties. Foreclosing future litigation of the issue on that ground is far different than doing so on the ground that the issue of fraud was waived because it was never resolved one way or the other in the prior proceeding. Here, the issue of fraud was squarely presented in the North

Carolina proceedings and finally resolved by a settlement and dismissal with prejudice that clearly implemented the express intentions of the parties — to extinguish the fraud claim for all time. The same was not true in *Brown*, where the parties agreed to the entry of judgment for the creditor but simply left unaddressed the issue of fraud.

II. WHILE COLLATERAL ESTOPPEL PLAINLY COMPELS THE RESULT REACHED BY THE COURT OF APPEALS, THIS COURT SHOULD AFFIRM ON THE BROADER GROUND THAT BANKRUPTCY COURTS MUST GENERALLY GIVE EFFECT TO CONTRACTS ENFORCEABLE UNDER STATE LAW BY WHICH LITIGANTS AGREE TO REFRAIN FROM MAKING PARTICULAR ALLEGATIONS IN THE FUTURE

Under the facts of this case, application of well-established principles of collateral estoppel requires affirmance of the decision below. All issues of fraud arising from the sale of Archer Manufacturing to petitioners have been resolved against petitioners by the judgment on the merits that resulted from voluntary dismissal of all pending claims with prejudice.

Plainly, though, the foundation of that stipulated judgment, and of its collateral-estoppel effect, is the agreement of the parties to resolve their dispute on terms that included the permanent and irrevocable release of plaintiffs' fraud claim. *See* pp. 15-20 *supra*. Respondent submits that because the parties entered into a settlement contract enforceable under state law, the same result should obtain even if the agreement of the parties had never been accompanied by a final judgment on the merits. On this basis, the courts below correctly rejected petitioners' nondischargeability claim on the basis of the contract that petitioners willingly entered into with respondent. The absence of a judgment, which is present here and is of course necessary for the application of collateral estoppel, should not allow a creditor who agrees not to assert fraud against a debtor to escape his bargain in the context of

a Section 523(a)(2) nondischargeability proceeding. On this basis, the decisions below are entirely correct not only in result reached, but in their reasoning as well.

A. State Law Defines The Property Rights Of A Creditor Against The Estate In Bankruptcy, And Petitioners' Sole Rights Are Those That They Retain Under Their Contract With Respondent

The "basic federal rule" in bankruptcy is that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Butner v. United States*, 440 U.S. 48, 54 (1979); *accord, e.g, Raleigh v. Illinois Dep't of Rev.*, 530 U.S. 15, 20 (2000). Absent "some federal interest requir[ing] a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner*, 440 U.S. at 55. Identical treatment of property interests in both federal and state courts serves several interests: "[T]o reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" *Id.* (quoting *Lewis v. Mfrs. Nat'l Bank*, 364 U.S. 603, 609 (1961)).

Petitioners' rights against respondent's assets, therefore, principally are determined by the law of North Carolina. Under that law, the release that petitioners granted respondent is a contract that, when "based on valuable consideration," *Talton v. Mac Tools, Inc.*, 453 S.E.2d 563, 565 (N.C. Ct. App. 1995), "is usually held to discharge all and sundry claims between the parties." *McGladrey, Hendrickson & Pullen v. Syntek Fin. Corp.*, 375 S.E.2d 689, 691 (N.C. Ct. App. 1989). *See also Merrimon v. Postal Telegraphcable Co.*, 176 S.E. 246, 248 (N.C. 1934) (contractual releases "buy peace from all future contention on then existing claims of every character"). Like any other contract, a release "is subject to avoidance by a showing that its execution resulted from fraud or mutual mistake." *Sykes v. Keiltex Indus., Inc.*, 473 S.E.2d

341, 344 (N.C. Ct. App. 1996). But petitioners do not argue before this Court that the release they signed suffers from any such defect. Pet. Br. 8 n.5.

Petitioners contracted to release respondent from "from any and every right . . . relating to the matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and deeds of trust executed contemporaneously herewith." J.A. 67. Under North Carolina law, this release contract was valid and, by its plain language, bought respondent peace from all future contentions that she had engaged in fraudulent conduct during the sale of Archer Manufacturing. The agreement is a "novation" that extinguished all previous obligations and claims and created a new obligation in the form of a $100,000 promissory note. *See, e.g., Tomberlin v. Long*, 109 S.E.2d 365, 368 (N.C. 1959) ("Novation implies the extinguishment of one obligation by the substitution of another." (internal quotation marks omitted)); *accord, e.g, Wilson v. McClenny*, 136 S.E.2d 569, 576 (N.C. 1964). Thus, petitioners come to federal court holding only such rights against respondent's estate as are spelled out in the contract and enforceable under state law — here, "to enforce the holder's rights and remedies . . . as provided in this Note." J.A. 74-75 (emphasis added).

Petitioners contend that they must be allowed to reassert their extinguished allegation of fraud for the purpose of showing that the note represents a debt for "money . . . obtained by . . . false pretenses, a false representation, or actual fraud," and is therefore nondischargeable. 11 U.S.C. § 523(a)(2)(A). But allowing petitioners to thus renew their claim of fraud would violate their contract and run directly counter to the principle identified in *Butner* of limiting creditors to their rights against the debtor's estate as defined by state law. As suggested in *Butner*, 440 U.S. at 55, such a course would inject tremendous uncertainty into the binding effect of validly-formed contracts that, at state law, would preclude creditors from raising issues of fraud. Moreover,

such a rule would provide a "windfall" to the creditor "merely by reason of the happenstance of bankruptcy," *id.*, since an extinguished allegation of fraud would thereby be given a second life. By releasing creditors from the burden of their bargain, while allowing them to retain its benefits, petitioners' interpretation of the Code would thus undermine state contract law in an important way.

B. This Conclusion Is Supported By The Important Role Of Private Settlements In The Context Of Bankruptcy

"[P]ublic policy wisely encourages settlements." *McDermott, Inc. v. AmClyde*, 511 U.S. 202, 215 (1994). This is true in the specific context of bankruptcy as well. Compromises and settlement agreements are authorized by Rule 9019(a) of the Federal Rules of Bankruptcy Procedure, and are "favored in bankruptcy." 10 L. King, ed., *Collier on Bankruptcy* ¶ 9019.031 (15th ed. 1993). The role of settlement in bankruptcy extends to compromise of creditors' actions "to have a particular debt declared nondischargeable." S. Snyder & L. Ponoroff, *Commercial Bankruptcy Litigation* § 9.12[3], at 9-121 (25th ed. 2002). *See also* L. LoPucki, *Strategies for Creditors in Bankruptcy Proceedings* § 6.06[H] (3d ed. 1997). This type of settlement is explicitly recognized in the Advisory Committee Note to Bankruptcy Rule 4004(c), which acknowledges that a bankruptcy court may defer the entry of the order granting a debtor's general discharge, because "[i]mmediate entry of that order . . . may render it more difficult for a debtor to settle pending litigation to determine the dischargeability of a debt and execute a reaffirmation agreement as part of a settlement." Fed. R. Bankr. P. 4004(c) advisory committee's note.

"The courts are uniform in their respect, desire, and appreciation of settlements in a bankruptcy case." R. Valencia, *The Sanctity of Settlements and the Significance of Court Approval: Discerning Clarity from Bankruptcy Rule 9019*, 78 Or. L. Rev. 425, 430 (1999). Indeed, "[t]he glue that

often holds the bankruptcy process together is the ability of parties to resolve disputes by settlement instead of litigation. If bankruptcy judges had to try a much larger percentage of matters than they currently do, the system would surely bog down." L. Clark, *Symposium Survey: Bankruptcy*, 28 Tex. Tech L. Rev. 299, 324 (1997). This Court has emphasized the important, even crucial, role that settlements play in the efficient operation of the bankruptcy process. *See Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc. v. Anderson*, 390 U.S. 414, 424 (1968) ("In administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts."); *Gardner v. New Jersey*, 329 U.S. 565, 581 (1947) ("compromise or settlement of claims" in bankruptcy is favored so that "interminable litigation might be ended and the interests of expedition in promulgating a plan of reorganization served").

These same policies that make settlements negotiated during bankruptcy important to the effective working of that process support recognition of settlements negotiated pre-bankruptcy. Of course, litigation that has been settled need not be tried in the bankruptcy court, and this conservation of judicial resources is no small matter. But the resources of the parties also will be conserved and, especially where a defendant ends up in bankruptcy, settlement may be the only means of resolving litigation in a way that does not consume most or all of the available resources. *See* LoPucki, *supra*, § 6.06(H), at 291-92 ("If the debt is not more than a few thousand dollars, the attorney's fees that would be incurred by each side in order to submit the matter for a judicial determination would probably exceed the amount truly in controversy.").

There can be no doubt that the ability of parties to settle a dispute is reduced by legal restrictions on the terms of a permissible settlement. *See United States v. Mezzanatto*, 513 U.S. 196, 208 (1995) ("[A]s a logical matter, it simply makes

no sense to conclude that mutual settlement will be encouraged by precluding negotiation over an issue that may be particularly important to one of the parties to the transaction."). Any rule that would prevent a potential plaintiff from relinquishing particular claims in a way that will bind him in the future would obviously make settlement of at least those claims impossible. Petitioners' approach here would apparently allow a claimant to agree that there has been no fraud, and, by making his intent clear, bind himself by a settlement judgment that would bar a new fraud suit in the future. But they would deny that settlement its binding effect in foreclosing assertions of the same fraud, when offered in the context of determining nondischargeability under Section 523(a)(2)(A).[7]

Such a bar to a party's ability to forswear categorically the making of a particularly inflammatory allegation — such as fraud — is odd, and radically changes the terms of the bargain that might otherwise have been struck. It is odd, because not every thought that passes through the mind of a potential plaintiff, or finds its way into a complaint, demands a judicial resolution. Normally, we take the plaintiff's word for it, and let drop an allegation if the aggrieved party concludes that it should no longer be pursued, for whatever reason. Refusing to do so — and keeping the innuendo of fraud alive to be revived in bankruptcy in the context of Section 523(a) — will certainly make the prospect of settlement on any specified terms less attractive to the defendant, and may on some facts prevent any settlement from being reached. Such a disruption

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[7] Contrary to petitioners' contention, Pet. Br. 21-22, once the issue of fraud is determined by settlement in a manner that is preclusive of all issues on which dischargeability depends, there is no separate issue of "nondischargeability" remaining to be resolved. Nondischargeability under Section 523(a)(2)(A) turns upon a showing that a debt is for money "obtained by . . . fraud." While the bankruptcy court has exclusive jurisdiction to make the ultimate determination of nondischargeability, that does not suggest that it can or must ignore the disposition of the underlying fraud issue reached by the parties.

of the settlement process and denial of the freedom to relinquish claims — and thus end disputes — should not be allowed absent compelling statutory grounds.

Nothing in the Bankruptcy Code's provisions calls for this result. To the contrary, when Congress intends to preclude a debtor from obtaining a discharge of a debt evidenced by settlement, it specifically so states. Section 523(a)(11) renders nondischargeable a debt "provided in any final judgment . . . entered in any court . . . , issued by a Federal depository institutions regulatory agency, *or contained in any settlement entered into by the debtor*, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." (emphasis added). In recent weeks, as part of the Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002), Congress added a new Section 523(a)(19) to the Code, which renders nondischargeable debts for "violation of any of the Federal securities laws, . . . or common law fraud, deceit, or manipulation in connection with the purchase or sale of any security" that result from "any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding" or "*any settlement agreement entered into by the debtor*." (emphasis added).

"[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Gozlon-Peretz v. United States*, 498 U.S. 395, 404 (1991); *accord Russello v. United States*, 464 U.S. 16, 23 (1983). That presumption is warranted here. In Sections 523(a)(11) and (a)(19), Congress has concluded that certain types of alleged misconduct are such that no settlement of those allegations can be allowed to render the resulting debt dischargeable. *See, e.g.*, 136 Cong. Rec. H13288, 13289 (daily ed. Oct. 27, 1990) (statement of Rep. Brooks) (Section

523(a)(11) was "narrowly crafted to hit only those who committed the worst abus[e]"); S. Rep. No. 107-146, at 16 (Section 523(a)(19) designed to close a "loophole" and "help defrauded investors recoup their losses"). And Congress plainly viewed these amendments as adding to other provisions of the Bankruptcy Code, such as Sections 523(a)(2) and (a)(4), which define broader categories of debts that already encompass those arising from the substantive conduct addressed by Sections 523(a)(11) and (19).

If, as petitioners contend, Section 523(a) categorically required that settlements be ignored for purposes of determining nondischargeability in bankruptcy, then the references in Sections 523(a)(11) and (a)(19) to settlements would be superfluous. As this Court has held, it is improper to read one subsection of Section 523(a) in a way that "would obviate the need for" another subsection that Congress has enacted. *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998) (courts are "hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of the same law" (internal quotation marks omitted)); *see also Meyer v. Rigdon*, 36 F.3d 1375, 1380 (7th Cir. 1994) (employing same rule in construing Section 523(a)(11)). In fact, these amendments are not mere surplusage, but rather show that when Congress wishes to afford settlements a disfavored status in nondischargeability proceedings, and thereby force debtors who wish to avoid nondischargeability to litigate a fraud allegation to its conclusion, Congress does so explicitly.

In summary, if adopted, petitioners' view that settlements in which a creditor agrees to relinquish claims of fraud for all time should be ignored in bankruptcy would result in more cases of alleged fraud being litigated to conclusion, since that would be the only way for the debtor to achieve real finality on the fraud allegation. No language in the Bankruptcy Code suggests that settlements should be given this disfavored status. In fact, language in the Code signals precisely the

contrary — that settlements are, if anything, more important to the working of the bankruptcy process than elsewhere in our courts and are ignored in determining dischargeability issues only when Congress explicitly so states.

C. Petitioners' Policy Arguments Do Not Justify A Special Bankruptcy Rule That Would, As A General Matter, Deny The Effect Of Settlements In The Context Of Nondischargeability Issues

There being no specific provisions of the Bankruptcy Code supporting their proposed rule ignoring the effect of settlements in the context of Section 523(a)(2) proceedings, petitioners resort to a series of policy arguments to make their case. These arguments fall far short of justifying petitioners' proposed rule.

1. The Principle That Bankruptcy Discharge Is Intended To Assist Only "Honest But Unfortunate Debtors" Does Not Support The Rule Petitioners Advocate

Petitioners argue that bankruptcy policy, expressed in several of this Court's decisions, favoring the honest but unfortunate debtor with the opportunity to have his debts discharged is inconsistent with allowing creditors to relinquish by settlement fraud claims, and thus render their settlement rights dischargeable. Petitioners allege that allowing creditors to settle their disputes in a manner preclusive of nondischargeability claims "would have potentially wide ranging consequences throughout bankruptcy law, and [would] threaten[] to open a gaping hole in [the Supreme Court's] repeated admonition that [] discharge is available only to the 'honest but unfortunate' debtor." Pet. 10.

There are several answers to this contention. First, the fact that parties have squarely confronted the issue of fraud, voluntarily resolved their differences, and agreed not to raise issues of fraud again means that for all relevant purposes, on the say-so of the parties most directly concerned, there was no

fraud. Taking that finding at face value, as we must, there is no offense to the honest but unfortunate debtor principle. Thus, as discussed above, *see* pp. 21-23 *supra*, *Brown*'s concern that a waiver theory not preclude examination of a debtor's conduct when an issue of fraud was never resolved one way or the other simply is not implicated.

Given that the parties have agreed that there have been no acts of fraud worthy of further pursuit, enforcement of the settlement agreement as written is fully consistent with this Court's decisions in *Cohen* and *Grogan*, each of which relied upon the Bankruptcy Code's policy of affording relief to the "honest but unfortunate debtor." *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998); *Grogan*, 498 U.S. at 287. These cases cited this policy in support of giving Section 523(a)(2) broad reach where fraud already has been proven, *Cohen*, 523 U.S. at 221-22, and of rejecting an increased burden of proving fraud under Section 523(a)(2) by clear and convincing evidence, *Grogan*, 498 U.S. at 287-88. But neither case concerns the antecedent question, presented in this case, of whether a bankruptcy court fraud inquiry is proper in the first place. Certainly, neither case suggests that the "honest but unfortunate debtor" policy forces a bankruptcy court to override a creditor's voluntary agreement, contained in a settlement contract, not to assert issues of fraud against a debtor.[8]

Indeed, the Bankruptcy Code itself provides that, unlike other potentially nondischargeable debts, a debt may be ruled nondischargeable under Section 523(a)(2) only if a creditor

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[8] Petitioners admit (Pet. Br. 25) that those cases disallowing pre-bankruptcy contracts concerning nondischargeability have done so only when a debtor stipulates that a debt will not be discharged. These cases rest on the traditional solicitude shown in bankruptcy to the debtor's right to a fresh start. *See* 11 U.S.C. § 524. Petitioners cite no case, and respondent has found none, suggesting that a creditor and debtor are somehow barred from reaching an enforceable pre-bankruptcy contract whose terms prevent the creditor from asserting fraud against the debtor.

requests a dischargeability hearing, and does so within 60 days after the first date set for the meeting of creditors. 11 U.S.C. § 523(c)(1); Fed. R. Bankr. P. 4007(c). Absent such a timely affirmative request, the Code thus contemplates that a nondischargeability claim will be lost, quite apart from any express agreement to relinquish it. Thus, presumably, creditors may choose, for any reason or no reason, to forgo an assertion of nondischargeability under Section 523(a)(2). There is no suggestion anywhere in the Code that the bankruptcy court has either the power or the duty to override that choice — or the choice to relinquish such a claim by contract — by initiating its own fraud inquiry to smoke out a "dishonest" debtor. To the contrary, courts construe the procedural requirements for a Section 523(a)(2) claim strictly against creditors. *See* 5 *Collier on Bankruptcy* ¶ 523.26[1].

At the same time that the Code thus leaves it to each creditor to determine whether to pursue a claim of non-dischargeability under § 523(a)(2), other provisions address directly the concern that dishonest debtors may misuse the bankruptcy process to their own advantage. In particular, Section 727(a) sets out ten separate grounds on which the bankruptcy court may conclude that the debtor should be denied any discharge at all. 11 U.S.C. § 727(a)(1) - (10). Under those provisions, on motion of the trustee, a creditor, or the United States Trustee, *see id.* § 727(c)(1), the bankruptcy court may deny any discharge to a debtor who commits any of a broad range of acts in the nature of fraud on the bankruptcy process, or upon his creditors, beginning one year before the filing of bankruptcy. *See id.* § 727(a)(2)(A). These provisions overcome the law's preference for discharge in bankruptcy where the debtor has engaged in "'intentional departure from honest business practices where there is a reasonable likelihood of prejudice.'" 6 *Collier in Bankruptcy* ¶ 727.01[4] (quoting *Kentile Floors, Inc. v. Winham*, 440 F.2d 1128, 1131 (9th Cir. 1971)).

The Code thus is entirely coherent and strikes a sensible balance in declining to second guess the litigation decisions of creditors to settle or abandon their claims, while creating a powerful tool in Section 727(a) to address egregious dishonesty carrying adverse consequences for the bankruptcy system and the creditors.

2. There Is Nothing Tricky Or Treacherous About Applying The Usual Rules Of Contract Interpretation To Preclude Further Assertion Of Contentions That Were Expressly Relinquished By A Prior Settlement

Petitioners and their *amici* rely (Pet. Br. 22-23; AARP *Amicus* Br. 6; Ohio *Amicus* Br. 10-11) on the suggestion that there is something tricky or treacherous about letting the dischargeability of claims be governed by settlements that may be binding against a creditor on the issue of fraud, and that there is a corresponding high likelihood that innocent people will somehow be taken advantage of. This is a highly exaggerated concern. As the district court noted, Pet. App. 24a, parties considering settlement of a fraud claim have a broad range of options as to the terms of any settlement.

Since the issue in any later bankruptcy may be whether the debt arose by fraud, the parties might resolve their case on the express understanding that the debt did, in fact, arise from fraud committed against the creditor. The result should be to bind the parties to that resolution of the fraud issue, and lead a bankruptcy court to rule that the debt is nondischargeable. Alternatively, the parties might (as they did here) include in their settlement language expressly releasing any fraud claim, thereby rendering settlement rights dischargeable in bankruptcy. Or, the parties could stipulate that no claims are released until such time as full payment is made of the obligations under the settlement with the result that the fraud claim remains unresolved and open to litigation by the bankruptcy court. These are only some of the options open to the parties, who are the masters of their own settlement

agreement. Their job, and that of their lawyers, is to secure a settlement that will have the binding — or non-binding — effects that they mutually desire.[9]

3. Refusal To Enforce A Settlement According To Its Terms Cannot Be Justified As Necessary To Protect Other Creditors

Petitioners express concern that allowing creditors to negotiate settlements in advance of bankruptcy could impair the rights of other creditors who are not parties to the agreement. Pet. Br. 24. Specifically, petitioners worry that a debtor may be motivated to settle claims for more than they are fairly worth, in order to turn them into dischargeable claims, and in the process allow the claiming creditor to receive more than his share from the bankruptcy estate. *Id.* at 26.

This marginal concern hypothesizes a debtor who, in a premeditated manner, sees his own impending bankruptcy ahead, contemplates the risk of a given claim being found to be nondischargeable, and then negotiates a settlement

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[9] It is noteworthy that the examples given by petitioners' *amici* do not support their contention that affirming the decision below will cause more people to be taken advantage of. AARP notes its "particular" concerns with "predatory mortgage lending" and "telemarketing fraud" perpetrated by "fly-by-night" companies. AARP *Amicus* Br. 4-5. But this concern focuses primarily, if not exclusively, on fraud by corporations. Discharge under Chapter 7 is available only for "individuals," 11 U.S.C. § 727(a)(1), and the nondischargeability provisions of § 523(a) have no application in the context of a corporate bankruptcy. The release of corporate entities from pre-existing debts is governed by provisions of chapter 11 that are not at issue in this case. *See* 11 U.S.C. § 1141(d).

The state *amici* express concern about discharge of debts that allegedly arise from sales of "securities." Ohio *Amicus* Br. 8. But, as discussed above, *see* pp. 29-30 *supra*, the recently enacted Section 523(a)(19) precludes discharge of "any settlement agreement entered into by the debtor" in a case alleging violation of securities laws or common-law fraud in connection with the purchase and sale of securities.

generous enough to buy out the fraud claim that would support nondischarge. That such opportunism is conceivable does not remotely suggest that it is now or has ever been a concern of substantial moment in the real world. It is only one of many forms of questionable behavior that lurk as temptations in any process that seeks to compromise and reconcile the legitimate interests of creditors with the debtor's procedural protections in bankruptcy and his ultimate right to a discharge and a fresh start.

In any event, as petitioners themselves note (Pet. Br. 25), this concern is already addressed by the Bankruptcy Code in two ways — through the laws of preference, *see* 11 U.S.C. § 547, and fraudulent conveyance, *see id.*§ 548. These provisions empower the bankruptcy trustee to avoid certain transfers from debtor to creditor in order to "facilitate the prime bankruptcy policy of equality of distribution among creditors." 5 *Collier on Bankruptcy* ¶ 547.01, *see* H.R. Rep. No. 95-595, at 177-78.

In order to avoid a preferential transfer, the trustee must show that (1) the transfer was for the benefit of a creditor; (2) the transfer was on account of an antecedent debt owed by the debtor before the transfer was made; (3) the transfer was made while the debtor was insolvent;[10] (4) the transfer occurred during the designated prepetition period (90 days or one year, depending on the facts); and (5) the transfer enabled a creditor to receive more than the creditor would have received if it were a Chapter 7 case, the transfer had not been made, and the creditor received a distribution under Chapter 7. *See* 11 U.S.C. § 547(b). Focusing on these five elements, a trustee need not prove either the intent of the debtor to prefer a certain creditor or the knowledge of the creditor that the debtor was insolvent, in order to exercise the preference

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[10] There is a rebuttable presumption that the debtor was insolvent if a transfer occurs during the 90 days before the bankruptcy petition was filed. *See* 11 U.S.C. § 547(f).

avoidance power. 5 *Collier on Bankruptcy* ¶ 547.01. Thus, the hypothetical situation suggested by petitioners — a debtor settles a claim for an unreasonably large amount in order to turn it into a dischargeable claim, thereby entitling the claiming creditor to a larger share in the bankruptcy estate — will on some facts amount to a proveable preferential transfer if it occurred within the preference period.

The fraudulent conveyance provisions of Section 548 offer competing creditors slightly different protections.[11] First, a trustee can avoid a transfer having the elements of common-law fraud — *i.e.*, if the debtor made the transfer or incurred the obligation with an actual intent to hinder, delay or defraud any entity to which the debtor was or became indebted. *See* 11 U.S.C. § 548(a)(1)(A). Second, a trustee can avoid a transfer without proof of the debtor's fraudulent intent if it was made while the debtor was insolvent in exchange for value that was less than equivalent to the value of the asset. *See id.* § 548(a)(1)(B).

Petitioners contend in a footnote, Pet. Br. 27 n.18, that the law of fraudulent conveyance would not provide sufficient protection against the risk of unfair treatment among creditors "because a creditor may defeat a fraudulent conveyance challenge merely by showing that he personally received 'approximately equivalent' or 'roughly equivalent' value." But if, as petitioners assume, these allegedly troubling settlements will be for amounts "roughly equivalent" to the value of the claims being settled, can this supposed abuse really justify overthrowing settlement agreements as petitioners advocate?

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[11] Under 11 U.S.C. § 544(b), a bankruptcy trustee can also use the applicable state laws of fraudulent conveyance to avoid a transfer. These state laws, generally modeled after either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, often have longer reach-back periods than the federal statute. *See* 5 *Collier on Bankruptcy* ¶¶ 548.01[2] & [3].

In addition, petitioners fail to discuss the category of fraudulent conveyance based on common-law fraud. In evaluating whether a transfer amounts to common-law fraud, courts often infer intent from the surrounding circumstances, drawing inferences and relying on any number of "badges of fraud." *See* 5 *Collier on Bankruptcy* ¶¶ 548.04[2][a] & [b]. Given the flexible character of this inquiry, pre-petition settlements with creditors paying excessive amounts to render a claim dischargeable may in some cases be subject to challenge as a deliberate defrauding of other creditors by diverting a portion of the estate assets to extinguish an otherwise nondischargeable claim.[12]

In sum, petitioners' concern about the hypothetical risk of misallocation of assets as between creditors does not remotely justify a categorical refusal to enforce otherwise binding settlement agreements in which a creditor relinquishes its right to raise issues of fraud against a debtor.

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[12] Some of petitioners' *amici* suggest that affirming the decision below would "give to the perpetrators of fraud a tantalizing incentive to settle any of their fraud-related debts just before filing bankruptcy." Ohio *Amicus* Br. 11; *see also* Brunstad *Amicus* Br. 5 (asserting that debtors may "settle their claims for illusory sums, and then file for bankruptcy to extinguish them"). But any such settlement should only put to rest a creditor's fraud claim where that creditor decides, for good and sufficient reasons, that his interests so dictate. Where the creditor has somehow been tricked into the settlement agreement, such conduct may be its own act of fraud which, when proven, may vitiate the settlement entirely or offer a basis for a claim of nondischargeability.

Petitioners failed to raise any such timely claim in this case and they assert no such contention here. *See* p. 6 *supra*; Pet. Br. 8 n.5. And, in all events, as the district court below noted, Pet. App. 25a, the facts of this case do not support any fraud-in-the-inducement claim given that $200,000 of the $300,000 settlement amount was paid immediately.

CONCLUSION

For foregoing reasons, this Court should affirm the judgment of the Court of Appeals.

Respectfully submitted,

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IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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INTRODUCTION AND SUMMARY

Respondent offers two reasons for affirming the judgment below. In her lead argument, she notes that, as part of the settlement, petitioners voluntarily dismissed their state court fraud action with prejudice. She asserts that, under North Carolina law, this voluntary dismissal must be treated as if it were an actual adjudication of the merits of the fraud claim in her favor.

Respondent did not make this argument below or in her brief in opposition to the petition for certiorari. The argument is therefore waived. In any event, it is meritless. As we explain below, North Carolina follows the traditional rule that collateral estoppel extends only to issues that were actually litigated. No court has ever determined whether respondent committed fraud.

Respondent's second argument fares no better. She asserts that, in the settlement agreement, petitioners promised "that the issue of fraud will not be raised again." Resp. Br. 10. The agreement, however, does not say this. Rather, it includes a standard release of every "right, claim, or demand" relating to the state court fraud action, in exchange for a cash payment and a promissory note. J.A. 63, 67.

The agreement does not resolve one way or the other whether fraud occurred, and it is completely silent on the question of how the debt reflected in the promissory note would be treated in bankruptcy. Moreover, the agreement makes clear that the release of claims does not limit petitioners' rights under the promissory note in any fashion. Accordingly, when respondent filed for bankruptcy without having paid on the promissory note, petitioners were well within their rights under the settlement agreement to assert that the debt, reflected in that note, was not subject to the discharge in bankruptcy. Indeed, because the nondischargeability action seeks nothing more than to enforce petitioners' rights under the note, the releases cannot be understood to bar the action.

In sum, respondent has not offered any persuasive reason for frustrating the clear command of 11 U.S.C. § 523(a)(2), which provides that respondent's debt to petitioners is exempt from discharge if the debt is "for money . . . obtained by . . . actual fraud." *See Cohen v. de la Cruz*, 523 U.S. 213, 215 (1998) (holding that Section 523(a)(2)(A) "prevents the discharge of all liability arising from fraud"). This is true notwithstanding that the debt has been "liquidated," and its amount "fixed," in a settlement agreement. 11 U.S.C. § 101(5)(A). Like the settlement by consent judgment that was at issue in *Brown v. Felsen*, 442 U.S. 127 (1979), the settlement agreement in this case "should not bar further inquiry into the true nature of the debt" reflected in the agreement. *Id.* at 138. Instead, petitioners are entitled to prove in the bankruptcy court that respondent's obligation to them under the promissory note arises from fraud.

I. THE SETTLEMENT OF A FRAUD CLAIM DOES NOT RENDER DISCHARGEABLE AN OTHERWISE NONDISCHARGEABLE DEBT.

The question presented in this case is whether the settlement of a fraud claim bars petitioners from proving in bankruptcy that the debt reflected in the settlement is nondischargeable on account of fraud. The settlement agreement in this case is silent on whether there had been fraud, on any question of dischargeability, and on the parties' rights in bankruptcy. Nothing in the text of the Bankruptcy Code suggests that such a settlement agreement converts an otherwise nondischargeable debt into a dischargeable one.

A. The Court Of Appeals' "Novation" Theory Cannot Be Reconciled With The Text Of The Bankruptcy Code Or *Brown v. Felsen*.

As we demonstrated in our opening brief, the court of appeals' reliance on a "novation theory" to defeat the application of Section 523(a)(2) cannot be reconciled with the text of the statute, much less with the logic of *Brown v. Felsen*. Just as a party to an agreement for settlement and release of

claims is barred from suing for the original amount demanded, and may sue to enforce only the rights reflected in the agreement, a plaintiff who has won a judgment in a fraud action is barred by the doctrine of res judicata from suing on the underlying claim, and may sue only to enforce the judgment. In both cases, the prior debt has been "novated." That fact notwithstanding, *Brown* holds that Congress intended bankruptcy courts to undertake the "fullest possible inquiry" to determine whether a judgment was traceable to fraud. *Brown*, 442 U.S. at 138. The same reasoning applies to an obligation resulting from an agreement that settles prior claims arising from fraudulent activity. That such an agreement is a "novation" in the sense that it completely and forever releases the underlying prior claims is simply irrelevant to whether Section 523(a)(2) allows a creditor to prove to the bankruptcy court that the obligation reflected in the agreement is nondischargeable because it is traceable to fraud.

B. Paragraphs (11) And (19) Of Section 523(a) Undermine Respondent's Construction Of The Rest Of Section 523(a).

Respondent offers only one argument from the text of Section 523(a) for construing the statute not to apply to the promissory note obligation. This argument relies on two recent amendments to Section 523(a). These amendments, codified in paragraphs (11) and (19), expressly refer to certain debts reflected in settlement agreements. Because Section 523(1)(2) does not expressly mention settlement agreements, respondent suggests that Congress intended that parties are barred from showing that fraud debts reflected in settlement agreements are nondischargeable under Section 523(a)(2). Resp. Br. 28-30.

Correctly understood, however, the references to settlements in paragraphs (11) and (19) undermine respondent's construction of Section 523(a)(2) and provide additional support for the proposition that the form of a debt is generally irrelevant to whether it is dischargeable in bankruptcy. Pet.

Br. 13-14. Both provisions were meant to expand Section 523(a), and thereby to make it harder, not easier, for perpetrators of fraud to escape their obligations to their victims. In particular, both provisions were intended to relieve creditors of the burden of showing that debts reflected in certain types of settlement agreements are traceable to fraud. In effect, for purposes of showing nondischargeability, these provisions require "the bankruptcy court [to] give preclusive effect," in favor of the creditor, to, among other things, "non-court approved settlement agreements" that "would not be given preclusive effect under the common law." *Meyer v. Rigdon*, 36 F.3d 1375, 1380 (7th Cir. 1994).

This hardly implies, as respondent suggests, that other provisions of Section 523(a) do not apply at all to debts contained in or resulting from settlement agreements. Rather, a creditor who is owed a debt for fraud, reflected in a settlement agreement, but not falling within paragraphs (11) or (19) of Section 523(a), is required in a nondischargeability proceeding to prove that the debt is traceable to fraud.

Paragraph (19) of Section 523(a), enacted in recent months in response to a wave of securities fraud scandals,[1] was intended to relieve creditors who settle claims of securities fraud from needing to prove, in bankruptcy court, the underlying allegations of fraud. Paragraph (19) states that a debt is nondischargeable if it: (A) "arises under a claim relating to [securities fraud]," and (B) "results from" a judgment, consent order, administrative order, or "any settlement agreement entered into by the debtor."

Senator Patrick Leahy, the sponsor of the legislation, explained that the purpose of the provision was to relieve state regulators who settle claims of securities fraud of the burden they would otherwise face under Section 523(a) to "reprove"

[1] Paragraph (a)(19) was added to the Bankruptcy Code as part of the Corporate and Criminal Fraud Accountability Act of 2002, Title VIII of Pub. L. No. 107-204 (the Sarbanes-Oxley Act of 2002), § 803, 116 Stat. 745, 801.

their fraud cases in nondischargeability proceedings in bankruptcy court. "[S]ettlements may not have the same collateral estoppel effect as judgments obtained through fully litigated legal proceedings." 148 Cong. Rec. S1785, S1787 (daily ed. Mar. 12, 2002) (statement of Sen. Leahy). Under Section 523(a)(19), however, all that needs to be shown to establish nondischargeability is that a "claim" of securities fraud resulted in a settlement agreement. A creditor need not establish, as petitioners seek to in this case, that the debt is in fact traceable to fraud.

Paragraph (11) of Section 523(a), which was enacted in response to a series of failures of savings and loan institutions, has been construed to have a similar effect. It was intended to make it harder for those responsible for savings and loan losses to escape liability for their wrongdoing by filing for bankruptcy. *See* 136 Cong. Rec. H13288, 13289 (daily ed. Oct. 27, 1990) (statement of Rep. Brooks).

That paragraph renders nondischargeable any debt that is "provided in any final judgment" or "contained in any settlement agreement," and that arises "from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. § 523(a)(11). As the Seventh Circuit explained, prior to the enactment of paragraph (11), Section 523(a)(4) already prevented debtors from discharging any debt for money obtained by fraud or "for fraud or defalcation while acting in a fiduciary capacity." *Meyer*, 36 F.3d at 1380. Paragraph (11), therefore, "requires the bankruptcy court [to] give preclusive effect," in any nondischargeability proceeding, to default judgments and settlements that would not otherwise be sufficient, by themselves, to establish fraud. *Id.*

Respondent thus is incorrect to suggest that Congress enacted paragraphs (11) and (19) to "force debtors who wish to avoid nondischargeability to litigate a fraud allegation to its conclusion." Resp. Br. 29. To the contrary, these provi-

sions were enacted to enhance the rights of fraud victims who had settled. Specifically, they were intended to relieve such creditors of the burden, once a settlement had been reached, of having to litigate the question of fraud in a nondischargeability proceeding.

In any event, there are two additional reasons for rejecting respondent's argument that, because paragraphs (11) and (19) expressly refer to debts resulting from settlement, paragraph (2) must not apply to such debts. First, the argument is inconsistent with the text of the Bankruptcy Code. Section 523(a)(2)(A) applies to "any debt" "for money . . . to the extent obtained by . . . actual fraud." *See Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998). A "debt" is defined as a "liability on a claim," 11 U.S.C. § 101(12), and a "claim," in turn, is defined broadly to mean a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *Id.* § 101(5)(A).

The promissory note at issue in this case was "liquidated," and its amount "fixed," by settlement. *See Black's Law Dictionary* 411 (7th ed. 1999) (defining "liquidated debt" to mean "debt whose amount has been determined by agreement of the parties or by operation of law"). Petitioners' right to payment is therefore "a 'claim' giving rise to a debt." *Cohen*, 523 U.S. at 218 (internal quotations and citation omitted). Because the exception to discharge set forth in Section 523(a)(2)(A) applies to "any debt" arising from fraud, respondent's "full liability" traceable to fraud "falls within the exception." *Id.* at 218, 219. Respondent's inference from paragraphs (11) and (19), in addition to failing on its own terms, would thus conflict with these definitional provisions of the Bankruptcy Code. *See* Pet. Br. 13-14; U.S. Amicus Br. 10-13.[2]

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[2] *See also Cohen*, 523 U.S. at 221; *Grogan v. Garner*, 498 U.S. 279, 290 (1991) (citing *Brown v. Felsen*, 442 U.S. at 138).

Second, respondent's argument "proves too much." *Field v. Mans*, 516 U.S. 59, 67 (1995). Paragraphs (11) and (19) refer not just to debts reflected in settlement agreements, but also to debts that have been reduced to judgment. Paragraph (2) refers to neither. Respondent's argument would require the conclusion that paragraph (a)(2) does not even apply to judgment debts resulting from fraud, and that Congress intended to overrule *Brown v. Felsen* by enacting paragraphs (11) and (19). Such an improbable result, under which even a creditor who has litigated a claim of fraud to a judgment would be unable to maintain that the debt was nondischargeable, would vastly contract the scope of Section 523(a). That reading cannot be squared with common sense or Congress' avowed intent, in enacting paragraphs (11) and (19), to make it *harder* for debtors who have committed fraud to discharge their debts in bankruptcy.

II. A SETTLEMENT DOES NOT HAVE ISSUE PRECLUSIVE EFFECT UNLESS IT CLEARLY SHOWS THAT THE PARTIES SO INTENDED.

As noted in our opening brief, *Grogan v. Garner*, 498 U.S. 279 (1991), holds that when the question of fraud is litigated to a judgment, collateral estoppel principles apply in subsequent proceedings to determine the dischargeability of debts reflected in the judgment. Pet. Br. 4. When a case is settled rather than litigated to a judgment, however, the settlement ordinarily does not give rise to issue preclusion unless it is clear that the parties intended the settlement to have such an effect. Respondent's principal argument for affirming the decision below is based on her erroneous reading of North Carolina law as departing from this general understanding of the doctrine of collateral estoppel.

As noted above, respondent failed to make this argument in the courts below. This Court exercises its authority to consider such arguments "only in exceptional cases." *Heckler v. Campbell*, 461 U.S. 458, 469 n.12 (1983) (internal quotations and citation omitted). In addition, because this argu-

ment purports to present a basis to affirm the judgment below that would obviate the need to reach the question presented in the petition, it was incumbent on respondent to raise it in opposition to certiorari. *See* S. Ct. Rule 15.2 ("Any objection to consideration of a question presented based on what occurred in the proceedings below, if the objection does not go to jurisdiction, may be deemed waived unless called to the Court's attention in the brief in opposition."); *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160, 171 (1999).[3] In any event, the argument has no merit.

A. Because Settlements Are Not "Actually Litigated," They Do Not Have Issue Preclusive Effect Unless The Parties Clearly Intended It.

Respondent contends that the settlement in this case, which was accompanied by a dismissal of the claim "with prejudice," is tantamount to a determination on the merits in her favor on the issue whether fraud occurred. She further contends that such a "determination" is entitled to collateral estoppel effect. But under traditional principles of preclusion, a settlement is entitled to res judicata effect alone. Collateral estoppel applies only to matters that are "actually litigated." *See, e.g.*, Restatement (Second) of Judgments § 27 (1982) ("When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim."). Indeed, parties often settle

[3] If this question of North Carolina law has not been waived, it is more properly addressed in the first instance by the lower courts on remand, following a reversal of the court of appeals based on its erroneous construction of Section 523(a) of the Bankruptcy Code. *See Roberts v. Galen of Virginia, Inc.*, 525 U.S. 249, 253-54 & 253 n.2 (1999) (per curiam) (reversing and remanding without addressing alternative grounds for affirmance as to which certiorari had not been granted); *cf. Butner v. United States*, 440 U.S. 48, 58 (1979) (state-law questions are best addressed by "[t]he federal judges who deal regularly with questions of state law in their respective districts and circuits").

precisely in order to avoid the collateral estoppel consequences that would attach to a litigated judgment.

Accordingly, as a matter of "standard preclusion doctrine," "settlements ordinarily occasion no *issue preclusion* (sometimes called collateral estoppel), unless it is clear, as it is not here, that the parties intend their agreement to have such an effect." *Arizona v. California*, 530 U.S. 392, 414 (2000) (emphasis in original).[4] This rule applies regardless of whether the underlying lawsuit is dismissed "with prejudice," as it was here. *See Lawlor v. National Screen Serv. Corp.*, 349 U.S. 322, 327 (1955) ("It is of course true that the 1943 judgment dismissing the previous suit 'with prejudice' bars a later suit on the same cause of action. It is likewise true that *the judgment was unaccompanied by findings and hence did not bind the parties on any issue . . . which might arise in connection with another cause of action.*") (emphasis added); *United States v. International Bldg. Co.*, 345 U.S. 502, 506 (1953) ("A judgment entered with the consent of the parties may involve a determination of questions of fact and law by the court. But unless a showing is made that that was the case, the judgment has no greater dignity, so far as collateral estoppel is concerned, than any judgment entered only as a compromise of the parties.").[5]

[4] *See* 18A Charles Alan Wright et al., *Federal Practice and Procedure* § 4443 (2002) ("consent judgments ordinarily support claim preclusion but not issue preclusion"); 18 James Wm. Moore et al., *Moore's Federal Practice* § 132.03[2][h]-[i] (3d ed. 2002).

[5] Respondent cites *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 385-86 (1996), for the proposition that "an express relinquishment of claims with prejudice[] satisfies the 'actually litigated' prerequisite to collateral estoppel." Resp. Br. 17. While *Matsushita* holds that a claim over which there is exclusive federal jurisdiction may be released in connection with a settlement of a state court lawsuit, nothing in *Matsushita* stands for the proposition for which it is cited by respondent.

B. North Carolina Follows Established Collateral Estoppel Principles.

Respondent errs in suggesting that North Carolina law departs from the general principles of collateral estoppel set forth above. To the contrary, "North Carolina currently recognizes [the doctrines of res judicata and collateral estoppel] in their traditional guise." *Thomas M. McInnis & Assocs., Inc. v. Hall*, 349 S.E.2d 552, 557 (N.C. 1986).[6] That includes the "actually litigated" requirement for collateral estoppel. *See, e.g., State v. Summers*, 528 S.E.2d 17, 20 (N.C. 2000) ("requirements for the identity of issues to which collateral estoppel may be applied" include requirement that "the issues must have been raised and actually litigated in the prior action").[7] As in other jurisdictions, the parties to a settlement in North Carolina can contract to ensure that their agreement

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[6] *See id.* (citing, *inter alia*, Restatement (Second) of Judgments § 27 (1982)); *State ex rel. Tucker v. Frinzi*, 474 S.E.2d 127, 128-29 (N.C. 1996) (quoting *Thomas McInnis & Assocs.*); 19 David E. Rigney, *Strong's North Carolina Index 4th* § 274 (Aug. 2002 update).

[7] *See also State ex rel. Lewis v. Lewis*, 319 S.E.2d 145, 148 (N.C. 1984); *Guilford County ex rel. Gardner v. Davis*, 473 S.E.2d 640, 642 (N.C. Ct. App. 1996) ("key question" in applying collateral estoppel "always concerns the issue(s) *actually litigated and decided* in the original action") (quoting *State ex rel. Lewis v. Lewis*, 303 S.E.2d 627, 630 (N.C. Ct. App. 1983) (emphasis in original), *aff'd*, 319 S.E.2d 145 (N.C. 1984)).

has issue preclusive effect.[8] Ordinary contract law principles apply in construing the terms of settlement agreements.[9]

The North Carolina decisions cited by respondent are not to the contrary. Respondent relies on five lower court decisions from the state for the proposition that the filing of a stipulation of dismissal with prejudice amounts to a "final judgment on the merits." Resp. Br. 16. But each of these decisions either undermines respondent's position or is simply inapposite.[10] Only two of the decisions actually apply collateral estoppel. One of these does not involve a settlement agreement or even a consent judgment;[11] the other case

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[8] *See Summers*, 528 S.E.2d at 20 ("[W]hen a fact has been agreed upon, or decided in a court of record, neither of the parties shall be allowed to call it in question, and have it tried over again at any time thereafter, so long as the judgment or decree stands unreversed.") (brackets in original; citations and internal quotation marks omitted); *Lewis*, 319 S.E.2d at 147; *see also Murakami v. Wilmington Star News, Inc.*, 528 S.E.2d 68, 70 (N.C. Ct. App. 2000) (because parties to contract are bound by its terms, collateral estoppel will bar litigation of issues "actually decided" during arbitration proceeding if agreement to arbitrate states that decision of arbitration panel is binding on contracting parties).

[9] *See Chappell v. Roth*, 548 S.E.2d 499, 500 (N.C. 2001); *id.* ("given the consensual nature of any settlement, a court cannot compel compliance with terms not agreed upon or expressed by the parties in the settlement agreement"); *cf. King v. King*, 552 S.E.2d 262, 264 (N.C. Ct. App. 2001) (consent judgment is a contract).

[10] Aside from the reasons discussed herein, the cases that involve a stipulation of dismissal may be inapposite for the reason that no stipulation of dismissal was filed in this case. The record contains a "notice of voluntary dismissal" filed by the plaintiffs "pursuant to Rule 41(a)" and signed by their counsel alone, J.A. 80, but no "stipulation of dismissal." *See* N.C. R. Civ. P. 41(a)(1) (distinguishing between notice of dismissal, filed by plaintiff, and stipulation of dismissal, signed by "all parties who have appeared in the action"); 2 G. Gray Wilson, *North Carolina Civil Procedure* § 41-2, at 34-35 (2d ed. 1995); *cf.* Fed. R. Civ. P. 41(a)(1) (drawing similar distinction).

[11] *See Miller Bldg. Corp. v. NBBJ N. Carolina, Inc.*, 497 S.E.2d 433 (N.C. Ct. App. 1998); *cf. Cudmore v. Howell*, 232 B.R. 335, 337

upholds the settled collateral estoppel principles explained above, *supra* at 8-11, by giving issue preclusive effect to a consent judgment that, unlike the settlement agreement in this case, expressly decided disputed issues.[12] The three remaining cases either use res judicata and collateral estoppel terminology interchangeably[13] or do not mention collateral estoppel at all.[14]

Respondent's cases amply confirm that "[t]he effect of a dismissal with prejudice is . . . to make the usual rules of res judicata applicable. " *Mumford v. Hutton & Bourbonnais*

(E.D.N.C. 1999) (giving collateral estoppel effect to default judgment entered after settlement negotiations fell through), *cited in* Resp. Br. 18.

[12] *NationsBank v. Am. Doubloon Corp.*, 481 S.E.2d 387, 391 (N.C. Ct. App. 1997) (stating that consent judgment, "having disposed of the issue of the value of the property, is binding upon the parties herein" where consent judgment specifically granted defendants credit of $30,000 for value of property); *id.* at 392-93 (consent judgment, which "expressly provided" for creditor's sale of collateral within thirty days after entry of judgment, "was a final judgment as to the issue" of commercial reasonableness of creditor's retention of collateral to date of entry of judgment); *id.* at 389 (describing issues resolved in consent judgment).

[13] *Caswell Realty Assocs. I, L.P. v. Andrews Co., Inc.*, 496 S.E.2d 607, 610, 611 (N.C. Ct. App. 1998) (after stating that "dismissal with prejudice is an adjudication on the merits and has res judicata implications," concluding that "there has been a sufficient identification of the causes of action in [first action] and the instant case so as to call the doctrine of res judicata and/or collateral estoppel into play") (citations omitted); *cf. NationsBank*, 481 S.E.2d at 393 ("res judicata and collateral estoppel"; "res judicata and/or collateral estoppel").

[14] *Barnes v. McGee*, 204 S.E.2d 203, 205 (N.C. Ct. App. 1974) (dismissal with prejudice, "unless the court has made some other provision, is subject to the usual rules of res judicata") (quoting Wright and Miller); *Bailey v. Gitt*, 518 S.E.2d 794, 796 (N.C. Ct. App. 1999) (voluntary dismissal rendered appeal moot; no mention of res judicata or collateral estoppel). *Cf. Nash County Bd. of Educ. v. Biltmore Co.*, 640 F.2d 484, 486-87 & 487 n.5 (4th Cir. 1981) (applying federal law of res judicata, but noting that "North Carolina law gives res judicata effect to consent judgments"), *cited in* Resp. Br. 16.

Co., 267 S.E.2d 511, 514 (N.C. Ct. App. 1980).[15] They do not show, however, that North Carolina gives issue preclusive effect to settlement agreements.

III. NOTHING IN THE SETTLEMENT PURPORTS TO RESOLVE THE QUESTION WHETHER FRAUD OCCURRED, TO RESOLVE QUESTIONS OF DISCHARGEABILITY, OR TO LIMIT PETITIONERS' RIGHT TO PAYMENT UNDER THE PROMISSORY NOTE.

Nothing in the settlement agreement in this case addresses the question whether fraud, in fact, occurred. Nor does the settlement purport to resolve whether the debt reflected in the note is dischargeable. Instead, the settlement agreement—which does not even mention bankruptcy, much less provide for the parties' rights in the event of a bankruptcy—reflects the parties' intent to leave the merits of the fraud allegation unresolved. Even more tellingly, the agreement and its accompanying releases expressly protect, rather than impair, petitioners' rights to collect the $100,000 due to them under the promissory note given as consideration for the releases.

A. The Settlement Agreement Is Silent As To Whether Fraud Occurred.

Contrary to respondent's assertions, nothing in the settlement agreement can be read to determine that the underlying allegations of fraud were false. Rather, the agreement is silent on that question.

Under the terms of the releases, petitioners gave up their right to bring suit against respondent for fraud, in exchange

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[15] *See* 2 G. Gray Wilson, *North Carolina Civil Procedure* § 41-4, at 41-42 (2d ed. 1995) (if dismissal pursuant to N.C. R. Civ. P. 41 "is with prejudice," it "preclud[es] further litigation under the doctrine of res judicata"); *Kabatnik v. Westminster Co.*, 306 S.E.2d 513, 515 (N.C. Ct. App. 1983) ("For purposes of res judicata, a voluntary dismissal with prejudice is an adjudication on the merits in favor of the opposing party.").

for a promissory note. The parties thus agreed that the dispute between them would be resolved without either side obtaining a judicial determination on the merits, one way or the other. J.A. 67 ("No party admits any liability or wrongdoing whatsoever in signing this agreement."). The agreement does not by its terms address the treatment of petitioners' claim in bankruptcy, and nowhere limits petitioners' right to contend that the debt reflected in the note would be nondischargeable.

Nothing in the agreement prevents petitioners from now arguing, in an effort to collect on the promissory note, that the debt reflected in that note is traceable to fraud. The agreement documents released respondent from "rights," "claims," and "demands." J.A. 67, 70. The assertion of nondischargeability, however, is none of these things. If it were, then such a "right," "claim," or "demand" would be barred, after a judgment, from being asserted under the doctrine of res judicata. As this Court held in *Brown*, however, nondischargeability is simply a response to the "defense of bankruptcy" asserted by respondent. *Brown*, 442 U.S. at 133.

Respondent's argument thus depends on construing the language of the settlement agreement to bar petitioners not merely from asserting "rights," "claims," and "demands" of fraud, but from making even *allegations* of fraudulent or other bad conduct. To this end, respondent uses the term "claim" interchangeably with "allegation" (and with "assertion," "contention," and "issue"). *See, e.g.*, Resp. Br. 1, 2, 10, 19, 24, 27, 31, 37.

To suggest that the settlement resolves "allegations" rather than "claims," however, is simply another way of saying that the settlement agreement deserves collateral estoppel effect in favor of respondent on the question whether fraud was committed. As is explained above (*supra* at 7-12), the general rule, and the governing law in North Carolina, is that while a settlement is entitled to res judicata effect, a settlement agreement does not receive collateral estoppel effect (either in favor of the plaintiff or of the defendant) as to any

underlying factual allegation unless the clear and expressed intent of the parties is that the agreement is to have such an effect. The application of this principle in this case is clear: because the settlement agreement before this Court does not contain any indication of such an intent, the agreement does not have any collateral estoppel effect. Although the settlement agreement contains a broad general release of claims, nothing in the agreement suggests that the parties intended it to have a broader issue preclusive effect.

B. The Agreement Does Not Limit Petitioners' Right To Payment Under The Promissory Note.

The settlement documents expressly carve out respondent's promissory note obligations from the releases. *See* J.A. 61-72. Because the nondischargeability action seeks nothing more than to enforce petitioners' rights under the note, the releases cannot be understood to bar the action. Petitioners are not asserting any claim against respondent that they gave up under the settlement agreement.

Indeed, the only "claim" at issue in this case is the "right to payment," 11 U.S.C. § 101(5)(A), that petitioners hold under the promissory note.[16] By contesting dischargeability in federal court, *see id.* § 523(c)(1), petitioners are simply protecting this claim using the tools that bankruptcy law affords to victims of fraud and other persons benefited by Section 523(a). Nothing in the settlement agreement or releases even mentions—let alone waives—petitioners' right under federal bankruptcy law to contest the dischargeability of respondent's promissory note debt in a hypothetical future bankruptcy proceeding.[17]

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[16] *See Cohen*, 523 U.S. at 218 ("right to payment" in this sense means "enforceable obligation") (quoting *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 559 (1990)).

[17] *Cf. Brown*, 442 U.S. at 137 (rejecting debtor's contention that if creditor had wanted to preserve objections to dischargeability for bankruptcy court review, creditor should have bargained prior to bankruptcy

Respondent thus misses the mark when she argues that a ruling in favor of petitioners would make it "impossible" for fraud defendants to settle because they could never be sure that released claims of fraud would not be resurrected and litigated in a subsequent nondischargeability proceeding. Resp. Br. 27. Petitioners are not asking this Court to resurrect any claim that they released in the agreement. While the state court complaint described damages that far exceeded the $300,000 agreed to in the settlement, J.A. 34-60, petitioners do not contend that they are entitled to assert a claim for this larger amount. Rather, petitioners assert only their right to receive payment on the $100,000 note that was given to them as part of the settlement, which right is subject to no release. Respondent's various arguments regarding the importance of settlements in the bankruptcy process, Resp. Br. 25-30, are simply misplaced.

IV. EVEN IF THE PARTIES HAD AGREED TO SETTLE THE ISSUE OF DISCHARGEABILITY, SUCH AN AGREEMENT MUST BE DISREGARDED AS INCONSISTENT WITH THE BANKRUPTCY CODE.

Even if the parties had agreed in the settlement to resolve questions of nondischargeability, such an agreement would have to be deemed unenforceable as inconsistent with bankruptcy law and policy.

Respondent has not overcome the rationale advanced in our opening brief for invalidating settlement provisions, entered into before bankruptcy and therefore without notice to creditors or bankruptcy court approval, that use prebankruptcy assets to purchase postbankruptcy benefits for prospective debtors. If such provisions were enforceable, prebankruptcy bargaining to purchase such provisions would inevitably diminish the pool of assets that would otherwise

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for stipulation that consent judgment resulting from settlement did not resolve issues of dischargeability under bankruptcy law).

be available to third-party creditors who were not parties to the negotiation of the provisions and who lacked an opportunity to object to them. Pet. Br. 24-27. To prevent a debtor from "externalizing" the costs of purchasing dischargeability by shifting those costs to absent third-party creditors, such provisions should be enforceable only if made or approved *after* a bankruptcy filing, subject to the requirements of notice to creditors and bankruptcy court approval.

Respondent points out that settlements, both prepetition and postpetition, are essential to the orderly operation of the bankruptcy process. This is certainly true. As the Advisory Committee Note to Bankruptcy Rule 4004(c) indicates, *see* Resp. Br. 25, questions of the dischargeability of debt are commonly settled during the course of a bankruptcy case, on notice to creditors. Respondent is also correct to assert that a creditor is entitled to forgo an assertion of nondischargeability—an act that, by itself, does not impair the rights of any other third-party creditors of the bankruptcy estate. *Id.* at 32. But neither of these situations gives rise to the problem present in a prepetition settlement releasing a creditor's right to assert the nondischargeability in bankruptcy of a prebankruptcy debt: the imposition of costs on third-party creditors without affording the creditors notice and an opportunity to be heard.

By the same token, prepetition settlements that liquidate disputed claims, but do not purport to resolve questions of dischargeability (such as, for example, the settlement agreement in fact reached in this case) are also commonly enforced. *Id.* at 26. In such settlements, no party has an improper incentive to obtain a personal benefit at the expense of an absent third party.

A settlement agreement reached prior to bankruptcy that purports to resolve questions of dischargeability is quite different from these other types of settlements that play a central role in any bankruptcy case. If a disputed claim is being liquidated, and the debtor is *also* obtaining a discharge of oth-

erwise nondischargeable debt, it follows as a simple matter of logic that the amount of the creditor's newly liquidated claim will be greater than it would have been had the claim been liquidated in a way that did not also involve a resolution of the nondischargeability question. Whenever that occurs, the value of the claims of other creditors will necessarily be diluted. Although it is true that the most egregious examples of such action may be redressable by suit against the creditor on a fraudulent conveyance theory, the far more sensible rule would be to subject any settlement involving rights that are unique to bankruptcy—such as questions of dischargeability—to the scrutiny of the bankruptcy court.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted,

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No. 01-1418

In the Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
PETITIONERS

v.

ARLENE L. WARNER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Section 523(a)(2)(A) of the Bankruptcy Code provides that a debt for money obtained by means of fraud is not dischargeable in bankruptcy. 11 U.S.C. 523(a)(2)(A). The question presented is whether an otherwise non-dischargeable debt becomes dischargeable if the parties enter into a settlement agreement resolving the amount of the debt.

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INTEREST OF THE UNITED STATES

Section 523(a)(2)(A) of the Bankruptcy Code, 11 U.S.C. 523(a)(2)(A), excepts from discharge in bankruptcy all debts arising from the debtor's fraud. The question presented in this case is whether a settlement agreement precludes a creditor from proving that the debtor's obligations under the settlement agreement arise from the debtor's fraud and are, therefore, nondischargeable under Section 523(a)(2)(A). The United States has an interest in preventing the discharge in bankruptcy of debts stemming from settlement agreements that resolve claims for fraud in connection with government programs under the False Claims Act, 31 U.S.C. 3729-3733, or under the common law. Thus, the United States, as a party, has urged courts to adopt the rule that a settlement agreement does not bar a

creditor in bankruptcy proceedings from proving fraud as the source of the settlement debt. *United States* v. *Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996); *United States* v. *Turner*, 179 B.R. 273 (Bankr. D. Colo. 1995).

STATEMENT

1. On May 22, 1992, Warner Manufacturing, Inc., respondent, Arlene Warner, and her spouse, Leonard L. Warner, sold the corporate assets of Warner Manufacturing for $685,000 to a corporation formed by petitioners. In late 1992, petitioners filed a suit in Superior Court of Guilford County, North Carolina, against Leonard Warner and Warner Manufacturing alleging fraud in connection with petitioners' purchase of the business. In March 1994, petitioners amended their complaint to add respondent and two other parties as named defendants and to allege additional claims of fraud and other misconduct. On May 8, 1995, petitioners again amended their complaint to add claims of intentional and negligent infliction of emotional distress. Pet. App. 2a.

On May 11, 1995, after extensive pre-trial discovery, the parties settled the case for $300,000. Pet. App. 2a. As part of the settlement, respondent and her spouse agreed to pay $200,000 in cash and to execute a secured promissory note for $100,000 payable in two installments due on November 11, 1995, and May 11, 1996. *Id.* at 3a, 31a. Petitioners also executed releases that waived any claims arising out of the matters in the state court suit, except for the obligations of respondent and her spouse to petitioners under the promissory note. *Id.* at 3a, 9a. Neither party admitted liability, and the settlement documents did not address whether respondent committed fraud. The documents also made no mention of bankruptcy. *Id.* at 3a.

On November 11, 1995, respondent and her spouse defaulted on the first payment due under the promissory note. On December 4, 1995, petitioners filed a collection suit in Superior Court in Guilford County. On February 5, 1996, respondent and her spouse filed for bankruptcy under Chapter 13 of the Bankruptcy Code (11 U.S.C. 1301 *et seq.*) and, on October 29, 1996, the case was converted into a case for liquidation and discharge of debts under Chapter 7 of the Bankruptcy Code (11 U.S.C. 701 *et seq.*). Pet. App. 3a.

2. The instant suit arose on January 29, 1997, when petitioners brought an adversary proceeding in the United States Bankruptcy Court for the Middle District of North Carolina seeking a judgment for the amount due under the promissory note and a declaration that the debt arose from fraud and was thus excepted from discharge under 11 U.S.C. 523(a)(2)(A).[1] Pet. App. 3a-4a. On May 27, 1997, respondent's spouse agreed to the entry of a consent judgment in which the bankruptcy court ordered the promissory note non-dischargeable under Section 523(a). *Id.* at 39a-41a. Respondent contested non-dischargeability, however, asserting the settlement of the state court suit as an affirmative defense. *Id.* at 5a. The bankruptcy court upheld respondent's affirmative defense, concluding that the releases executed by petitioners "effectively

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[1] Section 523(a)(2)(A) provides in relevant part that a discharge in bankruptcy "does not discharge an individual debtor from any debt * * * for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by * * * false pretenses, a false representation, or actual fraud." 11 U.S.C. 523(a)(2)(A).

released and extinguished the dichargeability claim which they now seek to assert." *Id.* at 35a.[2]

3. The district court affirmed. Pet. App. 17a-25a. The court reasoned that "the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy." *Id.* at 21a.

4. A divided panel of the Fourth Circuit affirmed. Pet. App. 1a-15a. The majority noted that the courts of appeals have divided on the issue whether a pre-petition settlement of claims for fraud extinguishes a creditor's claim that the settlement debt is excepted from discharge under Section 523(a)(2)(A) when the debtor files for bankruptcy relief before satisfying his settlement debt. *Id.* at 7a-9a. The majority observed that the District of Columbia and Eleventh Circuits have held that a settlement agreement does not extinguish a non-dischargeability claim under Section 523(a)(2)(A), because "examining the underlying fraudulent allegations leading to the settlement agreement best effectuates" the policy under the Bankruptcy Code of "not permitting the discharge of debts that Congress intended to survive bankruptcy." *Id.* at 8a (citing *United States* v. *Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996); *Greenberg* v. *Schools*, 711 F.2d 152 (11th Cir. 1983)). By contrast, the court explained, the Seventh and Ninth Circuit have embraced a "novation theory," under which "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then

[2] On June 25, 1998, petitioners twice attempted to amend their adversary complaint to allege fraud-in-the-inducement of the settlement agreement, but the bankruptcy court denied those requests. Pet. App. 4a-5a n.4.

dischargeable in bankruptcy." *Ibid.* (citing *In re Fischer*, 116 F.3d 388 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994); *Maryland Cas. Co.* v. *Cushing*, 171 F.2d 257 (7th Cir. 1948)).

The majority concluded that it would follow the "novation theory" line of decisions because, in the majority's opinion, "Congress did not intend that 11 U.S.C. § 523(a) be construed * * * so as to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a)." Pet. App. 8a. The court then examined "the validity and completeness of the bargained for agreement and release," and the court concluded that petitioners had released "all pending and future related personal claims" against respondent, including petitioners' non-dischargeability claim under Section 523(a)(2)(A). *Id.* at 9a.

Judge Traxler dissented. Pet. App. 10a-15a. He observed (*id.* at 13a) that in *Brown* v. *Felsen*, 442 U.S. 127 (1979), this Court held that a consent judgment against a debtor that is silent as to the cause of action upon which the judgment is based does not bar creditor from proving in bankruptcy proceedings that the debt reflected in the consent judgment is not dischargeable. "If, as the Supreme Court has declared, 'the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt,'" Judge Traxler saw "no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry." Pet. App. 15a (quoting *Brown*, 442 U.S. at 138). He also noted that petitioners' releases posed no bar to petitioners' non-dischargeability claim because "the releases specifically excepted the [respondent's] obligations under the promissory note." *Id.* at 15a n.*. Judge Traxler accordingly would have

allowed petitioners "to offer such proof as they might have to show that [respondent's] debt resulted from a fraud perpetrated upon them." *Id.* at 15a.

SUMMARY OF ARGUMENT

A. The court of appeals erred in embracing a novation theory under which a settlement agreement converts an otherwise non-dischargeable debt into a dischargeable contract debt. Section 523(a)(2)(A), 11 U.S.C. 523(a)(2)(A), excepts from discharge "any debt * * * to the extent obtained by" the debtor's "fraud." The Code, therefore, treats as irrelevant the form in which a debt appears or whether there have been prior efforts to reduce a claim based on fraud to settlement or judgment. A debt reflected in a settlement agreement fits within Section 523(a)(2)(A) as long as the creditor can demonstrate in bankruptcy proceedings that the debtor's underlying actions involved obtaining money or property by fraud. This Court has underscored the breath of Section 523(a)(2)(A)'s coverage by noting that the statutory language "prevents the discharge of all liability arising from fraud." *Cohen* v. *de la Cruz*, 528 U.S. 213, 215 (1998). A novation theory conflicts with the plain language of the Code by rendering debt procured by fraud dischargeable despite the clear prohibition of Section 523(a)(2)(A).

B. This Court's decision in *Brown* v. *Felsen*, 442 U.S. 127 (1979), confirms that the bankruptcy court may examine evidence extrinsic to the form of the debt to determine whether the debtor's liability is non-dischargeable because it arises from fraud. *Brown* holds that a consent judgment against a debtor that is silent as to the cause of action on which the liability is based does "not bar further inquiry into the true nature of the debt." *Id.* at 138. There is no principled reason to confine the Court's holding to consent judgments as opposed to settlement agreements that are not formally reduced to judgment. In both instances, the form of the claim underlying the debt changes from an unliquidated claim for fraud into a liquidated claim reduced to contract or judgment. But in both instances, the underlying nature of the debtor's behavior is unchanged.

Moreover, in both instances, the debtor's filing of bankruptcy "place[s] the rectitude of his prior dealings squarely in issue," and therefore principles of finality and repose do not warrant barring the creditor from asserting a claim of non-dischargeability in response to the debtor's "new defense of bankruptcy." *Brown*, 442 U.S. at 128, 133. And in both instances, the bankruptcy courts have the expertise to resolve the issue of non-dischargeability, which was not definitively resolved by the parties' resolution of their state court dispute.

C. The court of appeals likewise erred in concluding that petitioners released their non-dischargeability claims under Section 523(a)(2)(A). Although the settlement agreement, like the consent judgment in *Brown*, extinguished petitioners' state law claims for fraud, petitioners expressly preserved their rights to enforce respondent's settlement obligations. After respondent defaulted on those obligations and petitioners filed a collection suit on the settlement debt, respondent sought to discharge that debt in bankruptcy. Petitioners' claim of non-dischargeability under Section 523(a)(2)(A) does not seek to resurrect the state court litigation, to assert new grounds for recovery, or to recover sums beyond that agreed to in the settlement agreement. Rather, petitioners' non-dischargeability claim simply responds to respondent's bankruptcy by asserting the enforceability of the settlement debt notwithstanding respondent's bankruptcy. Petitioners' effort to enforce the settlement agreement in this

respect is no different than the creditor's effort to enforce the consent judgment in *Brown*.

D. The court of appeals' decision is inconsistent with the long-standing tradition of the Code to limit relief to the "honest but unfortunate debtor." *Cohen* v. *de la Cruz*, 523 U.S. 213, 217 (1998) (quoting *Grogan* v. *Garner*, 498 U.S. 279, 287 (1991)). The court of appeals' decision would permit debtors who have committed fraud to render their resulting debts dischargeable by the simple expedient of settling the debt and subsequently filing for bankruptcy. That result would defeat Congress's policy choice to protect innocent victims of fraud by rendering debts on account of fraud non-dischargeable in bankruptcy.

The court of appeals also was mistaken in concluding that a novation theory has the beneficial effect of encouraging settlement. Pet. App. 8a. In the first place, the policy goal of promoting settlement provides no basis for ignoring the plain text of Section 523(a)(2)(A), which makes debts arising from fraud non-dischargeable. In any event, it is not at all clear that a policy that turns debts that are non-dischargeable if either left unliquidated or reduced to judgment into dischargeable debts, if settled, would promote settlement. The only settlements encouraged by the court of appeals' decision are those induced by a desire to ensure that the settlement debt may be discharged in bankruptcy, even where the debtor actually committed fraud. Assuming the desirability of such settlement agreements, creditors would have little incentive to reach such agreements, and, of course, it takes two sides with proper incentives to settle a case. The court of appeals' decision likely would deter settlement by encouraging creditors to litigate an otherwise resolvable claim in order to obtain a non-dischargeable judgment of fraud

against a debtor, rather than risking a settlement that is dischargeable in bankruptcy.

ARGUMENT

A SETTLEMENT AGREEMENT DOES NOT BAR THE CREDITOR FROM PROVING THAT THE SETTLEMENT DEBT IS NON-DISCHARGEABLE UNDER SECTION 523(a)(2)(A)

Section 523(a) makes, "any debt" for, *inter alia*, "money, services [or] property" non-dischargeable "to the extent obtained by * * * fraud." 11 U.S.C. 523(a)(2)(A). The plain language of the Code, therefore, makes clear that any debt—for example, a note procured by fraud —is non-dischargeable, even if the defrauded creditor makes no pre-bankruptcy effort to enforce the note in court. Likewise, the text's broad coverage of "*any* debt . . . *to the extent* obtained by" fraud provides that an unliquidated claim for damages caused by fraud is non-dischargeable, even though there was no pre-bankruptcy effort to litigate the fraud action.

At the same time, this Court's precedents make clear that such debts do not become dischargeable and do not lose their fundamental character as debts procured by fraud simply because they have been reduced to a judicially-enforceable judgment. This is true whether the judgment results from a full adjudication of the dispute, see, *e.g.*, *Cohen* v. *de la Cruz*, 523 U.S. 213 (1998), or is the product of a settlement reached by the parties and reduced to a consent judgment, see, *e.g.*, *Brown* v. *Felsen*, 422 U.S. 127 (1979). The position of respondent and the court below then is that, even though debts procured by fraud are clearly non-dischargeable in the absence of any effort to litigate the claims and are equally non-dischargeable if they have

been reduced to judgment by settlement or adjudication, those same claims somehow lose their character as non-dischargeable debts procured by fraud if they are resolved through a settlement that is not reduced to a consent judgment.

In reaching that counterintuitive conclusion by adopting a "novation theory," the court of appeals articulated two distinct but related concepts. First, the court expressed its adherence to decisions embracing the principle that "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy." Pet. App. 8a. "The basic rationale of these cases is that, having accepted a settlement and released the underlying tort action, the plaintiff voluntarily accepted a contract debt, which is dischargeable under the bankruptcy laws, in lieu of pursuing a potentially non-dischargeable tort debt." *Id.* at 11a (Traxler, J., dissenting). Second, the court of appeals concluded that by releasing all claims arising out of matters in the state court suit, petitioners "completely released [respondent] from potential non-dischargeability claims under Section 523(a)(2)(A)." *Id.* at 9a. Neither of those theories justifies precluding petitioners from proving their non-dischargeability claim under Section 523(a)(2)(A).

A. A Novation Theory Conflicts With The Text Of The Code

1. Section 523(a)(2)(A) of the Bankruptcy Code excepts from discharge "any debt * * * for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by * * * false pretenses, a false representation, or actual fraud." 11 U.S.C. 523(a)(2)(A). This Court has held that the plain

meaning of that statutory language "prevents the discharge of *all liability arising from fraud.*" *Cohen* v. *de la Cruz*, 523 U.S. 213, 215 (1998) (emphasis added). That conclusion flows from two premises, both of which demonstrate that a creditor who reduces a disputed tort claim to a liquidated settlement debt is free to prove that the settlement debt arises from fraud and thus is non-dischargeable under Section 523(a)(2)(A).

First, Section 523(a)(2)(A) places no significance on the *form* of a debtor's liability. That provision treats as non-dischargeable "*any* debt * * * *to the extent* obtained by * * * fraud." 11 U.S.C. 523(a)(2)(A) (emphasis added). The Code defines a "debt" as "liability on a claim." 11 U.S.C. 101(12). A "claim" is defined, in turn, as a "right to payment, *whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, legal, equitable, or unsecured.*" 11 U.S.C. 101(5)(A) (emphasis added). The Code itself, therefore, expressly disclaims any concern whether the debt "is reduced to judgment, liquidated, [or] unliquidated." And a "right to payment" "is nothing more nor less than an enforceable obligation." *Cohen*, 523 U.S. at 218 (quoting *Pennsylvania Dep't of Pub. Welfare* v. *Davenport*, 495 U.S. 552, 559 (1990)). In sum, the relevant threshold inquiry under Section 523(a)(2)(A) is whether there is an "enforceable obligation of the debtor," and whether "the creditor has a corresponding right to payment," *ibid.*, not whether a settlement agreement was reduced to judgment.

Second, Congress intended that all debts originating in fraudulent conduct are non-dischargeable in bankruptcy. Congress employed the phrase "debt for" throughout the Code to mean "'debt as a result of,' 'debt with respect to,' 'debt by reason of' and the like,

connoting broadly any liability arising from the specified object." *Cohen*, 523 U.S. at 220 (citation omitted). In other words, Section 523(a)(2)(A) bars the discharge of debts "resulting from" or "traceable to" fraud. *Field* v. *Mans*, 516 U.S. 59, 61, 64 (1995). Accordingly, "[o]nce it is established that specific money or property has been obtained by fraud, * * * 'any debt' arising therefrom is excepted from discharge." *Cohen*, 523 U.S. at 218-219.

2. Those principles establish that a creditor must have an opportunity to show that a settlement debt arises from fraud and is, therefore, non-dischargeable under Section 523(a)(2)(A). A settlement debt satisfies the threshold condition of constituting a "debt" or "liability on a claim." 11 U.S.C. 101(12). The debtor has an enforceable obligation to pay the amount fixed in the agreement, and the creditor has a corresponding "right to payment, whether or not such right is reduced to judgment." 11 U.S.C. 101(5)(A). As the D.C. Circuit has explained, although a settlement agreement "alters the legal form" of the debtor's obligation, "it does not transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy." *United States* v. *Spicer*, 57 F.3d 1152, 1157 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996).

Of course, the creditor has the ultimate burden of proving a connection between a settlement debt and the debtor's fraud. Settlement agreements typically will not be conclusive evidence that the debtor's settlement liability arises from fraud. For instance, respondent here did not admit liability in the settlement agreement and, therefore, the agreement is silent on whether respondent committed fraud in connection with petitioners' purchase of the assets of Warner

Manufacturing. Pet. App. 3a. Accordingly, a creditor in such instances will have the burden of proving in bankruptcy court by a preponderance of the evidence that respondent committed fraud. *Grogan* v. *Garner*, 498 U.S. 279, 287 (1991). "Once it is established that specific money or property has been obtained by fraud, however, 'any debt' arising therefrom is excepted from discharge," including debts reflected in a settlement agreement. *Cohen*, 523 U.S. at 218-219. The courts below pretermitted that inquiry and petitioners accordingly should have the opportunity to demonstrate their claim of non-dischargeability under Section 523(a)(2)(A).

B. A Novation Theory Is Inconsistent With *Brown* v. *Felsen*

1. In *Brown* v. *Felsen*, 442 U.S. 127 (1979), this Court held that a settlement stipulation and resulting consent judgment against a debtor, which was silent on the cause of action that formed the basis of liability, did not bar the creditor from establishing in subsequent bankruptcy proceedings that the debt resulted from fraud and, therefore, was non-dischargeable under Section 17 of the Code (11 U.S.C. 35 (1976)), the predecessor to Section 523(a). 442 U.S. at 128, 129 n.1. The Court explained that "all debts arising out of conduct specified in § 17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.* at 138.

There is no reason for a different result when the settlement agreement has not been reduced to a consent judgment. In several fundamental respects, a settlement by private agreement is identical to a settlement by consent judgment. "A consent decree is pri-

marily a means by which parties settle their disputes without having to bear the financial and other costs of litigation." *Local No. 93, Int'l Ass'n of Firefighters* v. *City of Cleveland*, 478 U.S. 501, 528 (1986). "Consent decrees are entered into by parties to a case after careful negotiation has produced agreement on their precise terms. The parties waive their right to litigate the issues involved in the case and thus save themselves the time, expense, and inevitable risk of litigation." *United States* v. *Armour & Co.*, 402 U.S. 673, 681 (1971). Because "[t]he voluntary nature of a consent decree is its most fundamental characteristic," "it is the agreement of the parties, rather than the force of the law upon which the complaint was originally based, that creates the obligations embodied in a consent decree." *Local No. 93, Int'l Ass'n of Firefighters*, 478 U.S. at 521-522. And, like a settlement agreement, the binding effect of a consent judgment does not depend on resolution of the underlying issues in dispute. *Armour & Co.*, 402 U.S. at 681-682.

There also is nothing in the nature of a "novation" that differentiates a settlement agreement from a consent judgment for these purposes. As noted by the court of appeals (Pet. App. 9a n.8), a settlement agreement "operates as a merger" in which a contract claim is substituted for the tort claim. 15A C.J.S. *Compromise and Settlement* § 24(a), at 225 (1967). A judgment in the plaintiff's favor operates in the same respect by extinguishing the plaintiff's underlying claims and limiting him to a suit to enforce the judgment. Restatement (Second) of Judgments § 17(1) (1982) ("If the judgment is in favor of the plaintiff, the claim is extinguished and merged in the judgment."); *id.* § 18(1) ("When a valid and final personal judgment is rendered in favor of the plaintiff: * * * [t]he plaintiff cannot

thereafter maintain an action on the original claim or any part thereof, although he may be able to maintain an action upon the judgment.").

Moreover, the distinguishing features of a consent judgment provide no basis for limiting the holding of *Brown* to settlements by judicial decree rather than private contract. Because a consent decree is embodied in a judgment, the decree is subject to the court's continuing jurisdiction to enforce or modify. *Kokkonen* v. *Guardian Life Ins. Co. of America*, 511 U.S. 375, 381 (1994); *Rufo* v. *Inmates of Suffolk Co. Jail*, 502 U.S. 367, 378 (1992); *Local No. 93, Int'l Ass'n of Firefighters*, 478 U.S. at 523. A consent decree also "must spring from and serve to resolve a dispute within the court's subject-matter jurisdiction, * * * must come within the general scope of the case made by the pleadings, and must further the objectives of the law upon which the complaint was based." *Id.* at 525 (quotation marks, citations, and brackets omitted).

Although those differences may be relevant to a federal court's jurisdiction, see, *e.g.*, *Kokkonen*, *supra*, they have no bearing on the question presented in this case. The happenstance that a settlement agreement is or is not embodied in a judgment does not alter the dispositive fact that the claim that underlies the debt arises from fraud. Indeed, the Code removes all doubts on this issue, by disclaiming any concern whether a claim "is reduced to judgment." 11 U.S. 101(5)(A). Had the parties here resolved the state court suit by consent judgment, this case would be controlled by *Brown* and petitioners could attempt to show in a bankruptcy proceeding that the settlement debt is traceable to respondent's fraud. "There is no principled basis on which to conclude that [petitioners] should be barred from the opportunity to prove the true nature of the

debt just because the parties elected to keep their settlement agreement private and not to burden the state court with an unnecessary consent judgment." *In re Francis*, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998). In short, whether the parties' settlement takes the form of a consent judgment or a private contract, the relevant two-step inquiry is, first, whether the settlement creates a debt, *i.e.*, an enforceable obligation, and, second, whether the debt arises from fraud. *Cohen*, 523 U.S. at 218.

2. The Court's reasoning in *Brown* also confirms that neither principles of finality nor repose preclude bankruptcy courts from considering whether a debt embodied in a settlement agreement originates from fraud. "By seeking discharge," the Court observed, the debtor "place[s] the rectitude of his prior dealings squarely in issue," for the Code limits relief "to the 'honest but unfortunate debtor.'" 442 U.S. at 128 (quoting *Local Loan Co.* v. *Hunt*, 292 US. 234, 244 (1934)). *Brown* thus rejected the argument of the debtor that, because the litigation did not result in a finding of fraud, principles of claim preclusion or res judicata barred the creditor in bankruptcy proceedings from proving that the debtor's fraud gave rise to the consent judgment. The Court explained that, in pursuing a claim of non-dischargeability, the creditor "does not assert a new ground for recovery, nor does he attack the validity of the prior judgment." *Id.* at 133. Rather, the creditor "readily concedes that the prior decree is binding. That is the cornerstone of his claim." *Ibid.* The Court further explained that the creditor is "attempting to meet * * * the new defense of bankruptcy which [the debtor] has interposed between [the creditor] and the sum determined to be due him." *Ibid.* Noting the irony of a bankrupt relying on

principles of repose that he "has long since abandoned," the Court explained that "it would hardly promote confidence in judgments to prevent [the creditor] from meeting [the debtor's] new initiative." *Id.* at 134, 139.

As in *Brown*, petitioners hardly can be faulted for resolving their state court fraud suit and then later attempting to collect on the settlement debt. The parties' settlement had the salutary effects of avoiding the burdens, costs, and risks of litigation for both parties and the court. Those goals provided the parties with no incentive, however, to obtain a state court resolution of petitioners' underlying fraud allegations. "The object of a compromise and settlement is to compose differences and avoid litigation; it is intended, not to bring about a decision of the questions of law in dispute, but to pretermit them." 15A C.J.S., *supra*, § 1(a), at 171 (footnote omitted). Respondent, however, "upset the repose" underlying the parties settlement agreement by defaulting on her settlement debt and by filing for bankruptcy after petitioners brought suit to collect on the settlement debt. *Brown*, 442 U.S. at 133. By those actions, respondent "placed the rectitude of [her] prior dealings squarely in issue," and petitioners therefore are permitted to prove their claim of non-dischargeability in response to respondent's "new defense of bankruptcy." *Id.* at 128, 133.

Similarly, the dischargeability *vel non* of respondent's settlement debt is properly resolved in the bankruptcy court that has developed expertise on the issue. *Brown*, 442 U.S. at 136. That court is well-suited "to make an accurate determination whether respondent in fact committed the * * * fraud." *Id.* at 138. That question is "now, for the first time, squarely in issue," and is "the type [that] Congress intended that the bankruptcy court would resolve." *Ibid.*

C. Petitioners Did Not Release Their Claim Of Non-Dischargeability Under Section 523(a)(2)(A)

1. The court of appeals concluded that the petitioners "completely released [respondent] from potential non-dischargeability claims under Section 523(a)(2)(A)," because petitioners executed releases that "announced the complete waiver of all pending and future related personal claims against [respondent]." Pet. App. 9a. Making a similar point, respondent argues (Br. in Opp. 10) that *Brown* has no application where the creditor "voluntarily, and expressly, released an alleged fraud claim." A creditor's release of all pending or future claims relating to a state court fraud suit, however, does not extinguish his right to assert the enforceability of the bargained-for settlement debt when the debtor defaults on that debt and seeks its discharge in bankruptcy.

A settlement agreement substitutes a plaintiff's disputed claims for a new contract right to payment under the settlement agreement; indeed, that is the principle underlying a "novation" theory. See, *e.g.*, *Village of Kaktovik* v. *Watt*, 689 F.2d 222, 230 (D.C. Cir. 1982) ("An agreement to settle a legal dispute is a contract. Each party agrees to extinguish those legal rights it sought to enforce through litigation *for those rights secured by the contract.*") (footnote omitted) (emphasis added); accord 1 Am. Jur. 2d *Accord and Satisfaction* § 3, at 471 (1994) ("novation is a mode of extinguishing one obligation by the substitution of a new one"); Pet. App. 9a n.8 (explaining that settlement agreement caused "the substitution of a contract claim for a tort claim"). Because "a novation implies the extinction of an existing debt or obligation and its transition into a new one between the same or other parties, * * * a novation may * * * be the basis of the assertion of a

substantive right arising under the new agreement." *Accord and Satisfaction*, *supra*, at 471. For those reasons, a creditor's extinguishment of fraud claims in a release does not extend to his right to payment of the settlement debt.

That principle is illustrated by the settlement agreement in this case, in which petitioners agreed to release any claims relating to the subject matter of the state court suit but not to release any claims arising from respondent's failure to comply with her obligations under the settlement agreement. In the settlement agreement, petitioners agreed to execute releases with respect to "any and all claims * * * arising out of [the state court] litigation, *except as to amounts set forth in this Settlement Agreement.*" J.A. 68 (emphasis added). Similarly, in the general and mutual releases attached to the settlement agreement, petitioners explicitly excepted from the release any claims arising out of respondent's "*obligations under*" the promissory note. J.A. 72 (emphasis added).

A non-dischargeability claim under Section 523(a)(2)(A) is properly subsumed within petitioners' preserved right to enforce respondent's obligations under the settlement agreement. By pressing the non-dischargeability claim, petitioners are not re-asserting their state law causes of action; they are not asserting any new claim for recovery; and they are not seeking to collect amounts in excess of respondent's settlement debt. *Brown*, 442 U.S. at 133. Petitioners simply are asserting their rights to enforce the settlement agreement by claiming that those rights survive respondent's "new defense of bankruptcy" because respondent's settlement liability arises from fraud. *Ibid.* Thus, absent an express waiver of a creditor's claim of non-dischargeability under Section 523(a)(2)(A), a release does

not waive the creditor's right to assert non-dischargeability of a settlement debt incurred by the debtor in exchange for that release.[3]

In essence, the parties here are in the identical posture as the parties in *Brown*, who settled their dispute by agreeing to the entry of a consent judgment, which like a settlement agreement, draws its meaning and preclusive effect from the intent of the parties. *Arizona* v. *California*, 530 U.S. 392, 414 (2000); *Armour & Co.*, 402 U.S. at 681-682. Thus, in *Brown*, the debtor agreed to incur a debt to settle a fraud claim, and the form of the parties' settlement contained no finding of fraud and no disclaimer of the creditor's rights in bankruptcy. 442 U.S. at 128. The settlement here shares those same key elements. It is therefore irrelevant that respondent may have settled petitioners' fraud claims in order to "buy her peace," *i.e.*, so that she would never again have to respond to the allegations of fraud made in the state court suit. The same may be said for the debtor who settles a fraud claim by consent judgment without admitting liability, and *Brown* squarely

[3] Because the parties' settlement made "no mention of bankruptcy" (Pet. App. 3a), this case does not present the Court with any occasion to address an instance where a settling creditor executes an express waiver of a non-dischargeability claim under Section 523(a)(2)(A) of the Code. Similarly, because the parties' settlement is silent on the question whether petitioner committed fraud, this case does not involve the application of principles of issue preclusion or collateral estoppel which might otherwise bar a creditor from proving the elements of fraud in bankruptcy proceedings. *Grogan*, 498 U.S. at 284 n.11 (noting that "collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to § 523(a)"); cf. *Arizona* v. *California*, 530 U.S. at 414 (observing that although settlements have claim preclusive effect, they "ordinarily occasion no *issue preclusion* (sometimes called collateral estoppel), unless it is clear, as it is not here, that the parties intend their agreement to have such an effect.").

rejected any effort by the debtor to rest on principles of repose because it is the *debtor* who had disturbed the status quo ante by filing for bankruptcy and interposing a bankruptcy defense. *Id.* at 134, 139. Just as principles of claim preclusion or res judicata do not preclude a creditor from proving the non-dischargeability of a debt embodied in a consent judgment, petitioners' releases do not preclude them from establishing the non-dischargeability claim of a debt embodied in a settlement agreement.[4]

2. To be sure, a creditor may bargain for a specific provision in a release that explicitly preserves the ability to press a non-dischargeability claim in the event of bankruptcy. This Court should decline, however, to impose a default rule that requires creditors to take such action. At the time of the settlement, a debtor's bankruptcy is only "hypothetical." *Brown*, 442 U.S. at 135. This Court in *Brown* thus rejected the contention that the creditor "could have * * * preserved his dischargeability contentions for bankruptcy court review by bargaining for a stipulation that § 17 issues were not resolved by the consent judgment." *Id.* at 137. The Court explained that "[i]t makes little sense * * * to

[4] The court of appeals noted that petitioners, in their non-dischargeability complaint in bankruptcy court, incorporated by reference their fraud allegations in the state court suit. Pet. App. 4a n.3. Those allegations, however, are not being lodged to relitigate any new claim for recovery. Rather, the allegations in the state court proceeding are directly relevant to the question before the bankruptcy court, *i.e.*, whether the settlement debt is non-dischargeable because it arises from respondent's fraud. As the Court in *Brown* made clear, the bankruptcy court may examine the pleadings and discovery from a settled state court suit, as well as other evidence, in order to make an accurate determination of whether the debtor's liability results from fraud. 442 U.S. at 130, 138.

resolve a federal dischargeability question according to whether or not the parties in state court waived their right to engage in hypothetical litigation in an inappropriate forum." *Ibid.*

That conclusion is particularly warranted here, because the debtor presumably is the party with superior knowledge concerning the likelihood of his bankruptcy. Moreover, a default rule of dischargeability, unless the statutory policy of non-dischargeability is expressly incorporated, makes little sense as a practical matter. It is well-established that fraud claims reduced to final judgment via litigation or settlement are non-dischargeable. Accordingly, it is unclear why parties would assume that the same claims are presumptively dischargeable if settled without a consent judgment. It also is "unlikely that Congress . . . would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud." *Cohen*, 523 U.S. at 223 (quoting *Grogan*, 498 U.S. at 287). There is therefore no basis for forcing innocent victims of fraud to bear the risk of loss if they settle their fraud claims without explicitly preserving a claim of non-dischargeability under Section 523(a)(2)(A).

D. The Court Of Appeals' Decision Contravenes The Purpose Of Section 523(a)(2)(A) And Does Not Encourage Settlement

1. "The Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'" *Cohen*, 523 U.S. at 217 (quoting *Grogan*, 498 U.S. at 287); see *Brown*, 442 U.S. at 138. Thus, the Bankruptcy Act of 1867 provided that "no debt created by the fraud or embezzlement of the bankrupt * * *

shall be discharged under this act." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533. The Bankruptcy Act of 1898 similarly prohibited discharge of "judgments in actions for frauds, or obtaining property by false pretenses or false representations," Act of July 1, 1898, ch. 541, § 17, 30 Stat. 550, and the exception was broadened in 1903 to include all "liabilities for obtaining property by false pretenses or false representations." Act of Feb. 5, 1903, ch. 487, § 5, 32 Stat. 798. *Cohen*, 523 U.S. at 221; *Brown*, 442 U.S. at 138. In passing Section 523(a)(2)(A) as a "substantially similar provision," Congress carried forward the Code's long-standing tradition by "prevent[ing] the discharge of all liability arising from fraud." *Cohen*, 523 U.S. at 215, 221 (internal quotation mark omitted).

The purpose of Section 523(a)(2)(A) to limit relief to the "honest but unfortunate debtor" would be seriously undermined by the court of appeals' decision, which prevents even innocent victims of fraud from proving that a settlement debt results from fraud. The decision below "would allow a debtor to discharge a debt incurred by his own fraud by simply entering into a settlement agreement prior to declaring bankruptcy." *Greenberg* v. *Schools*, 711 F.2d 152, 154 (11th Cir. 1983). A settlement agreement, however, "makes the dishonest debtor no more honest, and no more entitled to the relief Congress intended to reserve for the honest debtor." *Spicer*, 57 F.2d at 1156. As a result, "[t]he intent of Congress to except from discharge debts incurred by means of fraud or defalcation could effectively be short-circuited by a simple execution of settlement." *In re Bobofchak*, 101 B.R. 465, 468 (Bankr. E.D. Va. 1989).

2. Those undesirable practical consequences are not outweighed by any countervailing policy to encourage

settlement. In the majority's view, allowing creditors to prove that settlement debts are non-dischargeable under Section 523(a)(2)(A) would "discourage the settlement of claims." Pet. App. 8a. As a preliminary matter, the salutary interest in promoting settlement does not justify disregarding the plain language of Section 523(a)(2)(A), which makes all debts arising from frauds non-dischargeable. In any event, it is not all clear that treating settlement agreements differently from consent judgments and adjudicated judgments would promote settlement. "[I]t would hardly promote confidence" in settlement agreements to prevent a creditor from demonstrating that settlement debts survive bankruptcy on account of the debtor's underlying fraud. *Brown*, 442 U.S. at 134.

The primary flaw in the court of appeals' analysis is that it takes two parties with proper incentives to settle a case. Although the rule embraced by the court of appeals would encourage debtors to enter settlements, it would make creditors correspondingly less apt to enter into such settlements. A rule excusing a debtor from making any payment of any debt arising from a settlement agreement likewise would clearly create incentives for debtors to settle, but it would significantly reduce any incentive for the creditor to settle. The court of appeals' settlement analysis discourages settlement by "forc[ing] an otherwise unwilling party to try [non-dischargeability] questions to the hilt in order to protect himself against the mere possibility that a debtor might take bankruptcy in the future." *Brown*, 442 U.S. at 135; see Pet. App. 24a (opinion of district court) (reasoning that a creditor concerned about risk of the debtor's bankruptcy "always has the option of going forward and seeking to secure a judgment of fraud against the debtor"). That regime, however, not only

would dissuade creditors from reducing debtors' liabilities though settlement, it would also unnecessarily waste the resources of both the parties and the judic ary. A creditor accordingly should have the opportunity to prove that a settlement debt is non-dischargeable under Section 523(a)(2)(A) because it arises from the debtor's fraud.

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded for further proceedings.

Respectfully submitted.

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No. 01-1418

In The Supreme Court Of The United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF OF OHIO AND 29 OTHER STATES AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE AMICI STATES

Ohio and 29 other amici States and Commonwealths write to urge the Court to reverse the judgment of the court of appeals. State and local governments are routinely required to don the mantle of "creditor" and aggressively pursue funds that are owed to the public. In many instances, the debts owed to these governmental entities result from the debtors' fraudulent misconduct involving health care services, consumer sales, and other activities regulated by the government. The Court's decision in this case will affect the States in our role as creditors when we confront debtors who have committed fraud. For the reasons explained below, we believe that the court of appeals erred in siding with the debtor in this case.

As is true in the business world, where many commercial disputes are resolved through settlements, we States often negotiate and settle with companies or individuals who owe money to us. Particularly when the underlying debt is tied to some fraudulent activity on the debtor's part, our ability to seek full recovery of all funds owed to us is critically important for both fiscal and public policy reasons. When we settle with such a debtor and he agrees to pay a set amount to resolve a fraud-related claim, we rightly expect that the debtor will remain obligated to pay that full amount, even if he later files bankruptcy. Congress has said exactly that in the Bankruptcy Code, and unless those provisions are enforced without exception, dishonest debtors who have already fleeced us or our citizens once may well be tempted to try to dodge their obligations again by settling their debts and then seeking to discharge them in bankruptcy. The amici States have a strong interest in protecting our citizens and our own treasuries from that outcome.

In holding otherwise, the court of appeals has established an environment that discourages creditors from settling fraud-related claims, for those creditors may well fear that the agreed-upon amount owed by the debtor will be discharged in a later bankruptcy filing. When fewer cases settle in this area, litigation expenses for the States and other creditors naturally increase. And the Fourth Circuit's reading of the Bankruptcy Code forces the States and other creditors who negotiate settlements involving fraud-related debts to do so with an eye toward each debtor's future financial wherewithal and possible plans to file bankruptcy, even though Congress surely intended to eliminate that concern for creditors.

SUMMARY OF ARGUMENT

The statutory rights afforded to victims of fraud trump those available to dishonest debtors seeking discharge through bankruptcy. By reversing the judgment below, this Court will confirm the validity of out-of-court settlements as efficient instruments that fully protect the rights of defrauded creditors, even when those debtors who owe money to the creditors file bankruptcy. States and other creditors who have settled claims involving frauds committed by debtors have long relied on the Bankruptcy Code's promise that those fraud-related debts are not dischargeable in bankruptcy. That reliance deserves respect, not only because it rightly rests on the words of the Code itself, but also because the public policy concerns that underlie those words are important. Congress has sensibly said that one who defrauds his creditors must remain liable for paying them back – even if the debtor later files bankruptcy – and those words and that policy deserve the teeth that Congress intended.

In light of Congress's policy judgment in this area, courts should eliminate that special treatment for defrauded creditors only upon a clear showing that the creditor-victim

has knowingly and intentionally waived that right. Where a settlement does not reflect such a waiver on its face, bankruptcy courts should permit creditors to show that the debtor's fraudulent conduct gave rise to the original debt, and then the agreed-upon amount of that debt reflected in the parties' settlement agreement should be treated as non-dischargeable obligation of the debtor in the bankruptcy court. The Fourth Circuit's approach short-circuits that process, improperly allowing a debtor to erase any connection between his past fraud and the related obligation to his creditor without any showing that the creditor knowingly agreed to waive the special protections that Congress has created for fraud victims.

Both in our role as bill collectors for the States and in our role as advocates for consumers, we Attorneys General rely on those Bankruptcy Code protections that treat as non-dischargeable any fraud-related debts. By reversing the circuit court's judgment, this Court will promote an environment that encourages parties to seek private settlements for debts owed, while still preserving the kind of bankruptcy-court protections for defrauded creditors that Congress intended.

ARGUMENT

I. The Decision Below Conflicts With The Letter And Spirit Of The Bankruptcy Code.

Because 11 U.S.C. 523(a)(2)(A) in the Bankruptcy Code says that a debt obtained by false pretenses or fraud is not dischargeable, bankruptcy courts must examine each debt to make certain that only the "honest but unfortunate debtor," is given the "fresh start" that the Bankruptcy Code allows. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). Yet the court below said that a debt tied to fraudulent conduct *is* dischargeable if (1) the debtor and the creditor have settled

on a new amount that the debtor should pay to resolve his obligation, and then (2) the debtor files bankruptcy.

If that approach is correct, then "through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a non-fraudulent one, and thereby immunize himself from the strictures of § 523(a)(2)." *United States v. Spicer*, 57 F.3d 1152, 1155 (D.C. Cir. 1995) (criticizing the approach that has now been adopted by the court below), *cert. denied*, 516 U.S. 1043 (1996). Congress has said no such thing, and that outcome improperly rewards the very debtors whom Congress has sensibly chosen to distinguish from the "honest but unfortunate" few whose debts can be forgiven in bankruptcy.

As this Court has said, the Bankruptcy Code's "central purpose . . . is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and 'enjoy a new opportunity in life and a clear field for future efforts, unhampered by the pressure and discouragement of preexisting debt.'" *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co.*, 292 U.S. at 244). But not all debtors are treated alike in the Code, and Congress has appropriately chosen to exempt some debts from discharge based on the circumstances that gave rise to the debt. Debts that cannot be avoided in bankruptcy include student loans, taxes and child support obligations, along with the kind of fraud-related debt that is at issue in this case. See 11 U.S.C. 523(a).

When analyzing Section 523(a), this Court has consistently taken a position that sharply contrasts with the approach adopted by the court below. The Court has explained that the Bankruptcy Code "has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief to only an honest but unfortunate debtor."

Cohen v. De La Cruz, 523 U.S. 213, 217 (1998) (citation and quotations omitted). And the Court has said that "it is unlikely that Congress . . . would have favored the interest in giving a perpetrator of fraud a fresh start over the interest of protecting victims of fraud." *Grogan*, 498 U.S. at 287.

Congress has also reserved to the bankruptcy courts the power to determine whether a particular debt fits within the discharge exception for fraud. As Professor Charles Seligson, speaking for the National Bankruptcy Conference, said when key provisions of the Code were before the Congress for adoption:

> [O]ne of the strongest arguments in support of the bill is that . . . a single court, to wit, the bankruptcy court, will be able to pass upon the question of dischargeability of a particular claim and it will be able to develop an expertise in resolving the problem in particular cases.

H.R. Rep. No. 91-1502 (1970), reprinted in 1970 U.S.C.C.A.N. 4156, 4160.

The Fourth Circuit's analysis, however, turns the whole process of careful bankruptcy-court scrutiny on its head. The court of appeals allowed the debtor in this case to argue that a settlement agreement conclusively demonstrates the creditor's abandonment of the Code's protections for the victims of fraud, even in the absence of any showing that the parties actually considered or agreed on the effect that the settlement would have on a later bankruptcy proceeding. That approach is not consistent with Congress's intent or with the approach followed by this Court in past cases.

In *Brown v. Felsen*, 442 U.S. 127 (1979), the Court examined the impact on a bankruptcy filing of an earlier

state-court case in which the creditor had filed a complaint alleging fraud against the debtor. The parties settled the case, but the state-court consent order reflecting their agreement did not include any findings regarding the fraud allegations. Even so, this Court held that the state-court judgment did not bar a bankruptcy court from later taking the necessary evidence to determine whether the debt was fraud-related (and therefore non-dischargeable). The Court explained that forcing the bankruptcy courts to give res judicata effect to such a prior state-court judgment (and the limited record on which it was based) "would undercut a statutory policy in favor of resolving Section 17[1] questions in bankruptcy court, and would force state courts to decide these questions at a stage when they are not directly in issue and neither party has full incentive to litigate them." *Brown*, 442 U.S. at 134.

The only notable difference between this case and *Brown* is that the agreement in that case was made part of a consent judgment in the state court. That distinction is not one that should lead to a different outcome for the debtor in this case. Just as the Court said in *Brown* that the state-court judgment in that case did not prevent a bankruptcy court from later considering bankruptcy discharge issues and exceptions left unmentioned in the parties' state-court settlement, so the Court should hold in this case that a bankruptcy court may still examine the role that fraud may have played in the original dealings between the debtor and the creditor, even though the parties' settlement agreement does not mention fraud.

Congress has established the bankruptcy courts as the expert venues for resolving the often-complex questions that arise when creditors hold competing claims to a limited asset pool. And Congress has spelled out for those courts the

[1] Section 17 has been replaced and is analogous to Section 523(a) of the Bankruptcy Code.

types of debts that may be discharged and those that may not. The judgment below undercuts the entire thrust of Congress's handiwork in this area.

Just as a number of lower courts have held that creditors are not allowed to convince debtors to sign advance agreements waiving the *benefits* of bankruptcy, see, e.g., *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (while "a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable," the debtor "may not contract away the right to a discharge in bankruptcy"); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) ("an agreement not to file bankruptcy is unenforceable"), so debtors who have committed fraud ought not be permitted to evade so easily the *costs* of their conduct either. Congress has attached a particular cost to that conduct by taking away the debtor's option of avoiding the debt in bankruptcy. That congressional intent ought to be carried out in this case and others where the debtor's own fraud gave rise to the debt initially.

At a minimum, courts should not lightly presume that a victimized creditor who has settled a case has willingly agreed to give away his right to be protected against the effect of a debtor's bankruptcy. Instead, the burden should be left on the debtor to prove that the parties actually agreed to that result. If the debtor cannot meet that burden, then, just as in *Brown*, the bankruptcy court should be free to uncover the actual facts surrounding the original debt.

II. The Fourth Circuit's Decision Improperly Eliminates A Key Statutory Protection For Victims Of Fraud.

Governmental entities, businesses and private citizens alike routinely resolve disputes through out-of-court

settlements. Those settlements typically cut litigation expenses for all parties involved, and also eliminate the need for trial or appellate judges to spend their time and energies on disputes that would otherwise end up before them.

And settlements play an important role in the resolution of the particular kind of claim at issue in this case: a claim that a debtor owes a creditor money because of the debtor's fraudulent conduct. Private individuals – like the petitioners here – as well as corporations may be the victims of fraud in a wide range of transactions, including those involving securities or contracts or consumer sales. State and local governments are surely not exempt from similar scams, and state Attorneys General in particular frequently pursue claims on behalf of their States or on behalf of residents who have been victimized by fraud and who are owed money as a result. Many times those individual fraud victims are unaware of their rights as creditors and may not be represented by counsel, while the debtors who have defrauded them may well be quite familiar with any available legal loopholes open to them.

The States have two key concerns that this case will affect. First, the States – like other creditors – are currently protected by a number of provisions in Section 523 of the Bankruptcy Code. A win for the respondent debtor in this case will undermine those protections across-the-board in ways that Congress did not intend, adversely affecting state and local governments in a variety of situations.

We may enter out-of-court settlements for tax payments, child support obligations, student loan repayments and other claims. All of these are currently non-dischargeable debts if the debtor later files for bankruptcy, and that status should be preserved for those debts, just as Congress intended.

The fraud exception at issue in this case, in particular, is a critical one for the States. We routinely investigate fraud in a wide range of settings, including Medicaid fraud, workers' compensation fraud, consumer fraud, or fraud involving government contracts. When we settle any of those cases with the defrauding debtor, we rely on the Code's language describing fraud-related debts as non-dischargeable, and the assurance we take from the Code – that any settlement amount that we agree to accept from such a debtor will not be wiped out if the debtor later files bankruptcy – is an important factor in our decision to settle those cases. If that assurance is eliminated, the value of settlement plunges for us and other creditors, for then clearly we would be much better off to steer clear of settlements in any cases involving debts linked to fraud. That outcome will drive up litigation expenses and will further burden our state court systems as we pursue ordinary collection remedies for the full amount of the original debts.

To be sure, even if the respondent debtor wins this case, governments and other creditors may be able to include language in future settlement agreements that will reserve the creditor's right to present in each bankruptcy case any relevant evidence pointing to the fraud-related origin of the debt, all in the hope that a bankruptcy court will then treat the settlement amount as a non-dischargeable debt if the debtor later files bankruptcy. But the exact wording of such a clause would be subject to negotiation and then subject to judicial scrutiny by the bankruptcy court in order to make sure that the creditor had not overreached by asking the debtor to waive its right to discharge debts. And given the large number of state and local agencies that act as creditors in this country – many of which have scarce resources available to cover legal expenses – the odds are good that particular magic words necessary to protect us will be omitted or misstated in at least some settlement agreements if we are

forced to operate in the kind of legal regime advocated by the respondent in this case.

Placing on creditors the obligation to include in each settlement agreement the kind of airtight language that will preserve non-dischargeable status for fraud-related debts will undermine the value of settlements as a low-cost alternative to litigation. The essence of *Brown v. Felsen* is that parties should not be required to focus on future bankruptcy issues before they actually arise. The same principle applies here as well.

Our second key concern in this case focuses on our obligation to protect resident citizens in their role as consumers. Each year, many of them are the victims of fraud in their day-to-day dealings with the sellers of goods and services. While many of those victims turn to state Attorneys General for help in resolving claims of shoddy workmanship or misleading promises in advertising materials or in contracts, surely many more victims try to cope with their fraud-related dilemmas on their own.

Just as we States do, a consumer who has been defrauded may settle with the defrauder for repayment of lost money. If the debtor then declares bankruptcy, however, and the debt owed to the consumer becomes dischargeable, the consumer comes out the loser. That outcome is not what Congress intended when it designated certain kinds of debts as non-dischargeable in bankruptcy.

And certainly the average consumer who does settle a fraud-related claim is unlikely to include language in the settlement agreement protecting his ability to later present evidence about the underlying fraudulent nature of the debt to a bankruptcy court should the defrauder file bankruptcy. Congress's words in Section 523 evidence an intent to help the victims of fraud by designating debts owed to them as

non-dischargeable, yet the approach adopted by the court of appeals will give to the perpetrators of fraud a tantalizing incentive to settle any of their fraud-related debts just before filing bankruptcy. Many unsuspecting fraud victims will then be stripped of the special protection that Congress intended to give them, just as they were first stripped of their assets by the perpetrator of the original fraud. That result is inconsistent with Congress's effort in Section 523(a) to penalize – not reward – the clever or slipshod debtor who falsely represents his goods or services to unsuspecting consumers.

CONCLUSION

The judgment of the court of appeals should be reversed.

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ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

BRIEF FOR AARP AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Bankruptcy Code § 523(a) renders debts "obtained by" fraud nondischargeable in bankruptcy. The question presented here is:

Whether a debt for money obtained by fraud becomes dischargeable merely because the debtor settles the claim for fraud and agrees in the settlement to return some or all of the amount obtained by the fraud.

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BRIEF FOR AARP AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

This brief is filed on behalf of AARP as amicus curiae in support of petitioners.[1]

INTEREST OF AMICUS CURIAE

AARP is a non-profit organization dedicated to addressing the needs and interests of people aged 50 and older. As the largest membership organization in America serving those over 50, AARP is greatly concerned about the rampant deception, fraud, and unfair practices perpetrated in a broad

[1] Letters of consent from both parties have been filed with the Clerk. No counsel for a party authored this brief in whole or in part, and no person or entity other than amicus curiae or its counsel made a monetary contribution to the preparation and submission of this brief.

range of consumer transactions. Older Americans are disproportionately victimized by such practices, and AARP thus supports laws and public policies designed to protect their rights and to preserve the legal means for redress when they are harmed in the marketplace. AARP believes that the interpretation of the Bankruptcy Code adopted by the decision below improperly undermines the ability of those victimized by fraud to obtain recovery for their injuries, contrary to both the language and the policies of the Code.

ARGUMENT

1. "The Bankruptcy Code has long prohibited debtors from discharging liability incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'" *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)). That long-settled policy is set forth today in § 523(a) of the Bankruptcy Code, which bars the discharge of "any debt . . . for money . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A). As this Court has repeatedly held, this provision broadly encompasses debts existing "on account of" fraud, *Cohen*, 523 U.S. at 217, "arising from" fraud, *id.* at 221, "resulting from" fraud, *Field v. Mans*, 516 U.S. 59, 61 (1995), or "traceable to" fraud, *id.* at 64.

All of these formulations make clear that the question of dischargeability in this context is simply one of *causation* – does the debt exist *because of* fraud? Put differently, if the debtor would not owe the creditor money but for the debtor's act of fraud, then the debt necessarily "results from" the fraud.

The central question in this case is whether a debt imposed by the settlement of a fraud claim results from the initial fraud. The answer is plainly yes: but for the initial act of fraud, the debtor would not have the creditor's money. To

be sure, the creditor must prove up in the bankruptcy case the initial act of fraud. *See Brown v. Felsen*, 442 U.S. 127, 138 (1979). But assuming the creditor proves that the debtor obtained the creditor's money by an act of fraud, nothing about an intervening settlement of the amount due to be returned to the creditor changes the fact that *the money is due only because the debtor obtained it by fraud in the first place*.[2] In other words, because the debt imposed by the settlement would not exist but for the initial fraud, the settlement debt is directly traceable to the fraud, and thus is nondischargeable under § 523(a).

2. This straightforward application of § 523(a) is fully consistent with the Act's fundamental policy of affording a "fresh start" only to "honest but unfortunate" debtors. *Grogan*, 498 U.S. at 287. The fact that a perpetrator of fraud has been persuaded to agree to refund all or part of the proceeds of his misconduct does nothing to change the fact that the money was initially obtained by an act of dishonesty (assuming, again, the creditor can prove up the fraud). And this Court has repeatedly recognized that bankruptcy policy does not seek to protect the perpetrator by denying his victims full restitution for their losses. *See Cohen*, 523 U.S. at 223 ("it is 'unlikely that Congress . . . would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting the victims of fraud'" (quoting *Grogan*, 498 U.S. at 287)).

3. The members of amicus AARP can attest to the harms that would be inflicted if the Court interpreted § 523(a) to

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[2] In the language of tort, the settlement would not be an "intervening" cause of (dischargeable) liability, absolving the debtor of the prior (nondischargeable) liability, because the settlement is not an "independent" causal factor – that is, the settlement liability was itself "caused or set in motion" by the same acts that created the initial monetary liability. Keeton et al., *Prosser & Keeton on the Law of Torts* 301-02 (5th ed. 1984).

allow perpetrators of fraud to use the bankruptcy laws as shield to protect themselves from their victims who seek recompense. It is well-established that older Americans are disproportionately likely to be victimized by fraud. *See, e.g.*, Friedman, *Confidence Swindles of Older Consumers*, 26 J. Consumer Affairs 20 (1992); Note, *Consumer Fraud and the Elderly: The Need for A Uniform System of Enforcement and Increased Civil and Criminal Penalties*, 4 Elder L.J. 201 (1996) (citing studies). Frauds against older consumers come in all forms; the most oft-cited include telemarketing scams, *see Consumer Fraud and the Elderly*, 4 Elder L.J. at 206-07; health-care frauds, *see id.* at 208-09; home repair swindles *see id.* at 209 .0; insurance frauds, *see* Frolik, *Insurance Fraud on the Elderly*, Trial (June 2001), and predatory lending schemes, *see* Walters & Hermanson, AARP, Public Policy Institute, *Older Subprime Refinance Mortgage Borrowers* 1-2 (2002) (available at www.aarp.org/ppi).

AARP has for over a decade focused particular attention on the problem of predatory mortgage lending, which disproportionately targets and impacts older and minority borrowers and threatens to undo years of progress in community development across the country. *See* U.S. Dep't of Treasury & U.S. Dep't of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report* 69-70 (2000) (available at www.huduser.org/publications) (noting that predatory lenders often target people who are elderly because they are likely to have built up significant equity in their homes, may live on fixed incomes and need cash for medical expenses or home repairs, and may be vulnerable to aggressive sales tactics); Woodstock Institute, *Two Steps Back: The Dual Mortgage Market, Predatory Lending and the Undoing of Community Development* 8 (1999) (available at www.woodstockinst.org) (finding that predators target vulnerable populations, including the elderly). Predatory lending, the Woodstock Institute reports, "has reached a scale where it has now been recognized as a major commu-

nity development problem . . . threaten[ing] decades of effort in promoting homeownership as a means of wealth creation and neighborhood stabilization." *Two Steps Back*, *supra*, at 39.

AARP has also drawn attention to the problem of telemarketing scams directed at older Americans. *See, e.g.*, AARP, *Telemarketing Fraud* (www.aarp.org/fraud); Princeton Survey Research Associates, *Telemarketing Fraud and Older Americans, An AARP Survey* (1996). Indeed, the problem of telemarketing fraud against older Americans was severe enough to provoke specific congressional action, the Senior Citizens Against Marketing Scams ("SCAMS") Act, 18 U.S.C. §§ 2325-2327. Nevertheless, telemarketing fraud remains a rampant problem. *See* Baginskis, *Telemarketing Fraud Upon the Elderly Shows No Signs of Slowing*, 11 Loyola Consumer L. Rev. 4 (1999); AARP, *Telemarketing Fraud*, *supra*.

Telemarketing scams, predatory lending and other frauds against older people inflict an especially acute harm, for the "likelihood that an elder person's income is fixed may make it extremely difficult to recover from a financial loss." Dessin, *Financial Abuse of the Elderly*, 36 Idaho L. Rev. 203, 205 (2000). At the same time, many such frauds are perpetrated not by reputable companies averse to bankruptcy, but by fly-by-night, "boiler-room" operations. *See* House Comm. on Gov. Operations, *The Scourge of Telemarketing Fraud: What Can Be Done About It?*, H.R. Rep. No. 102-421, at 3 n.3 (1991); *Consumer Fraud and the Elderly*, *supra*, 4 Elder L.J. at 207. Such marginal outfits almost certainly would have little if any concern about dropping into bankruptcy as a way to avoid paying agreed upon restitution for the consequences of unlawful behavior. To permit discharge of their debt would thus tear open a significant hole in the Bankruptcy Code, for the primary benefit of the debtors least deserving of the law's protection.

4. Adopting respondent's position in this case not only would expose older Americans and other victims of fraud to greater risk of nonrecovery, but would also have the adverse policy effect of encouraging these victims to litigate their fraud cases to judgment, rather than accepted negotiated resolutions. If a fraud claimant knows a settlement debt will be dischargeable even if she could prove in bankruptcy that the debt results from fraud, she will have a much greater incentive to bring that proof to judgment in the underlying fraud case and thereby protect the debt from subsequent discharge. Allowing her to prevent discharge by proving the fraud in the bankruptcy case would enable her to settle the claim with less concern for its loss in the event her victimizer declares bankruptcy.

On the other hand, that rule would not create a comparable settlement disincentive for fraud defendants, for two reasons. First, a settlement for less than the amount claimed would at least reduce the debt still enforceable in bankruptcy. Second, a debtor who settles a fraud claim will still have his day in court on the fraud claim – the settlement itself will not be res judicata against him. For that reason, the debtors *most* encouraged to settle under respondent's rule are those who expect or intend to use the settlement as shield in bankruptcy against the *legitimate* claims of fraud victims. And that is exactly contrary to the result the bankruptcy laws should encourage.

CONCLUSION

For the foregoing reasons, the judgment should be reversed.

Respectfully submitted,

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INTEREST OF THE AMICUS

Amicus curiae G. Eric Brunstad, Jr. respectfully submits this brief in support of the petitioners. Pursuant to Rule 37.3(a), all parties have consented to the filing of this brief.[1]

The undersigned *amicus* is a Visiting Lecturer of Law at the Yale Law School where he teaches courses on bankruptcy law, business reorganizations, and secured transactions. He has taught at Yale since 1992, and has also taught at the Harvard Law School.

In addition to teaching, the undersigned is the current Vice-Chair of the ABA Business Bankruptcy Committee. He is also a partner with the law firm of Bingham McCutchen LLP, practicing in the area of bankruptcy law and bankruptcy appeals. He is a contributing author to the Collier treatise on bankruptcy and is responsible for multiple chapters of the treatise. He has argued before the Court, and has participated in several bankruptcy cases in the Court.

The undersigned is interested in the administration of bankruptcy law, particularly matters relating to the administration of the discharge in bankruptcy. He has studied and published articles on a variety of bankruptcy topics, including the history of bankruptcy law and the evolution of the discharge. The basic perspective of the undersigned is that, although it is vital to recognize the critical importance of the discharge to insolvent debtors, it is also vital to ensure

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1. Pursuant to Supreme Court Rule 37.6, *amicus curiae* states that no counsel for any party to this dispute authored this brief in whole or in part and no person or entity, other than *amicus curiae*, made a monetary contribution to the preparation or submission of this brief. To the extent not previously filed, copies of the relevant letters of the parties consenting to the filing of this brief are lodged herewith.

the integrity of the bankruptcy system by preventing the discharge of obligations arising in connection with fraudulent activities. Consistent with Supreme Court Rule 37.1, the purpose of this brief is to bring to the Court's attention matters that other parties do not intend to address, particularly relating to historical matters bearing on the discharge issues arising in this case, the role of the bankruptcy courts as courts of equity, and the overall operation of the bankruptcy laws as is relevant to this case.

STATEMENT

In May of 1992, petitioners Elliot and Carol Archer (the "Archers") purchased a manufacturing company from respondent Arlene Warner and her husband, Leonard Warner (collectively, the "Warners"). (JA 41, ¶ 28). Thereafter, the Archers filed suit against the Warners in state court alleging fraud in the transaction. (JA 34). On the eve of trial, the parties entered into a settlement agreement resolving the litigation and, ultimately, a pending criminal indictment against Leonard Warner. (JA 61-63).

The terms of the settlement provided that the Warners would pay the Archers $300,000. (JA 61). This consisted of a $200,000 cash payment combined with a promissory note for $100,000 payable in two installments. (JA 61-62, ¶¶ 1, 2). In exchange, the Archers agreed to release the Warners from all claims related to the state court litigation. (JA 63). The release specifically excluded the Archers' debt to the Warners under the promissory note. (JA 67).

Shortly after the parties entered into the settlement, the Warners defaulted on the note. (JA 87, ¶ 6). When the Archers brought suit in state court to enforce the note, the Warners filed for relief under chapter 13 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq*. (JA 86, 87, ¶¶ 2, 11). The immediate

effect of the filing was to prevent the Archers from continuing their state court collection action. *See* 11 U.S.C. § 362(a). Thereafter, the Bankruptcy Court converted the Warners' case to a liquidation proceeding under chapter 7. *See* 11 U.S.C. § 1307. (JA 87, ¶ 3).

During the chapter 7 case, the Archers commenced an adversary proceeding in the Bankruptcy Court seeking a determination that the Warners' debt to them was nondischargeable on the ground, *inter alia*, that the obligation was for money or property obtained by fraud. *See* 11 U.S.C. § 523(a)(4); *see also* Fed. R. Bankr. P. 4007. (JA 89, ¶ 18). Leonard Warner did not contest the issue of nondischargeability, and the court entered a consent judgment against him. (JA 12, ¶ 16). In contrast, Arlene Warner did contest the nondischargeability of the debt. She alleged that the underlying liability did not involve any fraud by her, and that the settlement barred the Archers from asserting fraud as a basis for denying her discharge. (JA 93).

The Bankruptcy Court agreed with Arlene Warner's second argument, concluding on the basis of the settlement that the Archers "effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant." (Pet. App. 35a). The District Court affirmed, also concluding that the settlement agreement barred inquiry into the fraudulent basis of the underlying debt. (Pet. App. 20a-25a). On further appeal, a panel of the Court of Appeals likewise affirmed, with one judge dissenting. *In re Warner*, 283 F.3d 230 (4th Cir. 2002).

In affirming the judgment, the Court of Appeals reasoned that the settlement agreement extinguished the Archers' fraud claim by substituting in its place a contractual obligation for the payment of money. *Id.* at 237. In the court's view, this "novation" properly foreclosed further inquiry into the nature of the underlying obligation for discharge purposes. *Id.* at 236. The court reasoned that its approach would promote settlements. *Id.*

In reaching this conclusion, the court sided with the Seventh and Ninth Circuits, which also have refused to look through the terms of a settlement agreement if the agreement released all underlying fraud claims in exchange for a contractual debt. *See In re Fischer*, 116 F.3d 388 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994); *Maryland Casualty Co. v. Cushing*, 171 F.2d 257 (7th Cir. 1948). In contrast, the court acknowledged that its view was contrary to the approach taken by the D.C. and Eleventh Circuits. Under this second approach, a settlement agreement does not preclude a claim of nondischargeability if the creditor can demonstrate that the underlying debt involved fraud on the part of the debtor. *See United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983).

SUMMARY OF ARGUMENT

The history of the discharge in bankruptcy is one of an expanding concept marked by three interrelated themes: the promotion of relief for the "honest but unfortunate debtor," the corresponding denial of relief for obligations arising from fraud, and the generous exercise of the equitable powers of the bankruptcy courts to ensure the fulfillment of both goals. For over a century, the courts have been empowered to sift the circumstances surrounding the treatment of claims in bankruptcy to ensure that liabilities involving fraud do not find shelter within the bankruptcy system. Because the decision of the Court of Appeals effectively abandons the logic, history, and purpose of this tradition, and is contrary to the structure and operation of the Bankruptcy Code, reversal is warranted.

Under the decision below, a debtor may effectively convert a nondischargeable debt for fraud into a fully dischargeable contractual obligation by the simple expedient

of entering into a settlement agreement that offers a contractual promise of payment in exchange for a release of the prior liability. Thereafter, the debtor may freely default on the obligation with the knowledge that bankruptcy law will release the debtor from his or her burden, even though the underlying obligation would not have been dischargeable absent the settlement. The professed virtue of this procedure is that, by sanctioning the conversion of nondischargeable fraud claims into dischargeable contractual obligations, it encourages debtors accused of fraud to enter into settlements in which they promise restitution to their victims in exchange for a release. But by the same token, it also encourages the perpetrators of fraud to settle their claims for illusory sums, and then file for bankruptcy to extinguish them. In the final analysis, for debtors that fail to honor the terms of their settlements, the rule embraced by the court below effectively compromises the integrity of the bankruptcy system by offering shelter for defaulting perpetrators of fraud.

Nothing in the Bankruptcy Code compels or even suggests this result. On the contrary, the very purpose of the rule prohibiting the discharge of liabilities associated with fraudulent conduct is to limit the scope of bankruptcy relief to obligations that are free from the taint of fraud. As a matter of contract, a settlement agreement may release a debtor from the burden of the creditor's suit. That should not mean, however, that the same settlement agreement can prevent a bankruptcy court from examining the underlying nature of a settled obligation to ensure in the administration of the Nation's bankruptcy laws that the debtor's discharge applies only as Congress intended.

For over a century, this Court has instructed that, in the administration of bankruptcy proceedings, substance must not give way to form, and the courts must apply the salient

provisions of the bankruptcy laws to effectuate their underlying policies. This Court has especially adhered to that teaching in the application of the debtor's discharge in bankruptcy, concluding specifically that a state court consent judgment entered on a settled fraud claim would not preclude the bankruptcy court from examining the underlying nature of the claim for discharge purposes. *See Brown v. Felsen*, 442 U.S. 127 (1979). In order to limit discharge relief as Congress intended, the Court should reach the same conclusion in this instance and reverse the judgment below.

ARGUMENT

A. Although the History of the Discharge in Bankruptcy Is One of an Expanding Concept, Relief Has Been Limited to the "Honest But Unfortunate Debtor."

For much of English history, a debtor who could not pay his or her debts was treated as a criminal offender. Prior to the nineteenth century, imprisonment for debt was common, and in the words of one seventeenth-century English jurist:

> If a man be taken in execution, and lie in prison for debt, neither the plaintiff, at whose suit he is arrested, nor the sheriff who took him, is bound to find him meat, drink, or clothes; but he must live on his own, or on the charity of others; and if no man will relieve him, let him die in the name of God, says the law; and so say I.[2]

2. Peter J. Coleman, Debtors and Creditors in America 5 (1974) (quoting Sir Robert H. Hyde, J.). *See* G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 Bus. Law. 499, 519-21 & n.89 (2000) [hereinafter "*Brunstad, Bankruptcy*"] (discussing the practice of imprisonment for debt under English law).

Not surprisingly, the earliest English bankruptcy laws were little more than debt-collection devices intended to repress insolvent obligors.[3] A revised version of the first English bankruptcy statute went so far as to prescribe the death penalty for fraudulent debtors.[4] Under certain circumstances, mutilation of the debtor was also authorized.[5] By 1705, however, English law began to experiment with the concept of a discharge in bankruptcy to relieve honest but unfortunate bankrupts from the burdens of impossible indebtedness.[6]

In the United States, imprisonment for debt was also common well into the nineteenth century.[7] During periods of

3. *See* 1542, 1 Hen. 8, ch. 4, § 1 (Eng.); 1571, 13 Eliz., ch. 7, § 1 (Eng.); 1604, 1 Jam. 1, ch. 15, § 9 (Eng.); *Brunstad, Bankruptcy, supra* note 2, at 515-16.

4. *See* Gerrard Glenn, *Essentials of Bankruptcy: Prevention of Fraud, and Control of Debtor*, 23 Va. L. Rev. 373, 381 (1937) (under English law, "the failure of a bankrupt to surrender to the court, perjury upon his examination, and the fraudulent concealment of assets, were all made hanging offenses").

5. *See* Louis Edward Levinthal, *The Early History of English Bankruptcy*, 67 U. Pa. L. Rev. 1, 17 (1919) (observing that pillory and the loss of an ear were the "penalt[ies] imposed upon [the] debtor who failed to show that bankruptcy was due solely to misfortune").

6. *See* 1705, 4 Anne, ch. 17, § 7 (Eng.); *see also Brunstad, Bankruptcy, supra* note 2, at 515-56 & n.60 (discussing this statute). The origins of the discharge in bankruptcy are truly ancient. The Bible states: "At the end of every seven years you shall grant a release. And this is the manner of the release: every creditor shall release what he has lent to his neighbor; he shall not exact it of his neighbor, his brother, because the Lord's release has been proclaimed." *Deut.* 15:1-2. *See also Brunstad, Bankruptcy, supra* note 2, at 523-25 (discussing the history of debt forgiveness in bankruptcy law).

7. *See Brunstad, Bankruptcy, supra* note 2, at 519, 521 & n.91 (discussing the practice of imprisonment for debt in the United States, and its eventual abolishment).

financial turmoil, insolvent obligors would often fill the jails, prompting agitation for relief.[8] In response to the profound economic crisis generated by the war with France in 1799, and a succession of failed land speculations, Congress was moved in 1800 to enact the Nation's first bankruptcy law.[9] Although unpopular and short-lived, the Act provided a discharge for many insolvent merchants, including Robert Morris, the great financier of the Revolution, who at the time had spent three years in the Prune Street Jail in Philadelphia for debts of about $12 million from failed land speculations.[10]

Under the Act of 1800, discharge relief was proscribed if a creditor could show "any ficticious or false debt" or that the debtor had lost significant sums through gambling.[11] Beset with

8. *See id.*, at 519; Charles Warren, Bankruptcy in United States History 18-19, 55-57, 69-72, 95-105 (1935) [hereinafter "*Warren, History*"].

9. Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (1800) (repealed 1803); *see Warren, History, supra* note 8, at 18-19 (discussing events leading to the enactment of the Act of 1800); F. Regis Noel, A History of the Bankruptcy Clause of the Constitution of the United States of America 124-33 (1918) [hereinafter "*Noel, History*"] (same).

10. *See Brunstad, Bankruptcy, supra* note 2, at 517; Bankruptcy Act of 1800, ch. 19, § 34, 2 Stat. 30 (1800) (repealed 1803) (providing that "every such bankrupt shall be discharged from all debts by him or her due or owing, at the time he or she became bankrupt"); Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. 325, 346-47 (1991) [hereinafter "*Tabb, Discharge*"] (discussing the discharge under the Act of 1800); 1A Collier on Bankruptcy, ¶ 14.01 at 1246.1 (14th ed. 1979) (explaining that a discharge under the Act of 1800 required the consent of two-thirds of the debtor's creditors).

11. Bankruptcy Act of 1800, ch. 19, § 37, 2 Stat. 31-32 (1800) (repealed 1803).

criticisms that the act was too lenient on debtors and facilitated fraud, Congress repealed the measure shortly after its passage.[12]

Following the extended economic crisis occasioned by the depression of 1837, Congress subsequently enacted the Nation's second bankruptcy law in 1841.[13] Like the Act of 1800, the new law allowed a discharge.[14] At the same time, it also expanded the grounds for denying discharge relief, including "if [the] bankrupt shall be guilty of any fraud or willful concealment of his property."[15] Like the Act of 1800, this measure proved controversial, and Congress repealed it in 1843.[16]

Following the Panic of 1857 and the widespread dislocation caused by the Civil War, Congress enacted the Nation's third bankruptcy law in 1867.[17] This act further liberalized the

12. *See Noel, History, supra* note 9, at 124-33 (discussing enactment and repeal of the Act of 1800); 3 Joseph Story, Commentaries on the Constitution 8 (1833) (criticizing the repeal of the Act).

13. Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (1841) (repealed 1843); *see Warren, History, supra* note 8, at 55-57, 69-72 (discussing events leading to the enactment of the Act of 1841).

14. *See* Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 443-44 (1841) (repealed 1843); *Tabb, Discharge, supra* note 10, at 351-52 (discussing the discharge under the Act of 1841); 1A Collier on Bankruptcy, ¶ 14.01 at 1247 (14th ed. 1979) (explaining that a discharge under the Act of 1841 could be blocked by a majority of creditors filing written dissents asserting just cause).

15. Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 443-44 (1841) (repealed 1843).

16. *See Noel, History, supra* note 9, at 134-44 (discussing events surrounding the enactment and repeal of the Act of 1841).

17. Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (1867) (repealed 1878); *see Warren, History, supra* note 8, at 95-105 (discussing events leading to the enactment of the Act of 1867).

availability of a discharge.[18] At the same time, it also expanded the grounds for its denial, including if the debtor was guilty of "any fraud or negligence in the care [of his property]," "any false or fraudulent entry in any book of account or other document, with intent to defraud his creditors," or "any fraud whatever contrary to the true intent of this act."[19] The act also specifically excepted from discharge all debts "created by the fraud or embezzlement of the bankrupt or by his defalcation as a public officer, or while acting in any fiduciary capacity."[20] Somewhat longer-lived than its predecessors, the law endured until Congress repealed it in 1878.[21]

Congress's next bankruptcy law, the Bankruptcy Act of 1898, further liberalized the availability of the discharge while again excepting a variety of frauds from the scope of the Act's discharge provisions.[22] As initially enacted, section

18. *See* Bankruptcy Act of 1867, ch. 176, § 34, 14 Stat. 533 (1867) (repealed 1878); *Tabb*, *Discharge*, *supra* note 10, at 359-60 (discussing the discharge under the Act of 1867); 1A Collier on Bankruptcy, ¶ 14.01 at 1247 (14th ed. 1979) (explaining that a discharge under the Act of 1867 required the debtor's assets to equal fifty percent of claims, unless the debtor obtained the consent of a majority of creditors, and observing that this requirement was modified to make discharge easier to obtain by amendment to the Act in 1874).

19. Bankruptcy Act of 1867, ch. 176, § 29, 14 Stat. 531-32 (1867) (repealed 1878).

20. *Id.*

21. *See Noel*, *History*, *supra* note 9, at 145-56 (discussing events surrounding the enactment and repeal of the Act of 1867).

22. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), amended by the Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed

(Cont'd)

17 of the Act excepted from discharge "judgments in actions for frauds, or obtaining property by false pretenses or false representations." 11 U.S.C. § 35 (repealed 1979).[23] *See Bullis v. O'Beirne*, 195 U.S. 606, 615 (1904) (construing this provision). Dissatisfied with this provision, Congress amended it in 1903, replacing the term "judgments" with the broader concept of "liabilities."[24] The legislative history to this amendment indicates that the change was made "in the interest of justice and honest dealing and honest conduct" and was intended "to exclude beyond peradventure certain liabilities *growing out of* offenses against good

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1979). *See Noel*, *History*, *supra* note 9, at 157-80 (discussing the enactment of the Act of 1898). The discharge provisions of the Act of 1898 were considerably more generous than those of the Acts of 1800, 1841, or 1867. *See* Bankruptcy Act of 1898, § 14, 30 Stat. 550 (repealed 1979); *Tabb*, *Discharge*, *supra* note 10, at 366-68 (discussing the discharge under the Act of 1898); 1A Collier on Bankruptcy, ¶ 14.01 at 1247-1260.1 (14th ed. 1979) (discussing the discharge under the Act of 1898 and the various amendments to the Act). The Act of 1898 is the predecessor to the current Bankruptcy Code, 11 U.S.C. § 101 *et seq*. In drafting the Act of 1898, Congress distinguished between circumstances that would result in the complete denial of a discharge to the debtor, and debts that were not subject to the debtor's discharge. The former were set forth in section 14c of the Act, and the latter in section 17. *See* 11 U.S.C. §§ 32, 35. The current Bankruptcy Code likewise maintains this distinction. For example, section 727 describes the circumstances in which a court may deny a debtor a discharge in a chapter 7 case. *See* 11 U.S.C. § 727. In contrast, section 523 prescribes categories of debts excepted from the scope of the debtor's discharge. *See* 11 U.S.C. § 523.

23. Bankruptcy Act of 1898, ch. 541, § 17a, 30 Stat. 550-51 (1898) (repealed 1979).

24. Ch. 487, § 5, 32 Stat. 798 (1903) (repealed 1979).

morals." H.R. Rep. No. 1698, 57th Cong., 1st Sess., 3, 6 (1902) (emphasis added).[25]

Explaining the essential purpose of the discharge provisions, this Court repeatedly stressed the law's animating policy of affording bankruptcy relief to the "honest but unfortunate debtor." As summarized in *Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934):

> One of the primary purposes of the Bankruptcy Act is to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes. . . . This purpose of the act has been again and again emphasized . . . in that it gives the honest but unfortunate debtor . . . a new opportunity in life. . . . The various provisions of the Bankruptcy Act were adopted in light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act.

Conversely, the Court stressed the inappropriateness of affording discharge relief to certain wrongdoers, including the perpetrators of fraud. For example, in *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904), the Court refused to apply the discharge to excuse a debtor's obligation to support his family:

> The bankruptcy law should receive such an interpretation as will effectuate its beneficent

25. Congress subsequently amended section 17 numerous times, further expanding its scope. *See* 1A Collier on Bankruptcy, ¶ 17.01 at 1575-80.2 (14th ed. 1979). Of particular relevance, the amendments in 1938 and 1960 further broadened the fraud exception, rendering additional liabilities nondischargeable. *See id.* at 1577-78.

> purposes. . . . Systems of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive. . . . Unless positively required by direct enactment the courts should not presume a design on the part of Congress, in relieving the unfortunate debtor, to make the law a means of avoiding enforcement of the obligation, moral and legal, devolved upon the husband to support [his family].

See also McIntyre v. Kavanaugh, 242 U.S. 138, 142 (1916) ("It was an honest debtor, and not a malicious wrongdoer, that was to be discharged.") (citation omitted); *see generally Edwards v. Kearzey*, 96 U.S. 595, 602 (1877) (observing that imprisonment for debt "is right for fraud, but wrong for misfortune. . . Where there is no fraud, it is the opposite of a remedy.").

With the increase of debtors seeking bankruptcy relief following the passage of the Acts of 1867 and 1898, courts increasingly faced the task of deciding whether particular debts associated in some fashion with fraudulent conduct should fall outside the scope of the discharge provisions. Of particular significance are two lines of cases that illustrate the extent to which courts looked through the form of a particular debt to determine if the obligation in question arose out of fraud, thereby rendering the obligation nondischargeable.

1. Under the Acts of 1867 and 1898, Courts Routinely Looked Through Contractual Obligations to Determine the Presence of Fraud for Purposes of Determining Dischargeability.

Prior to the 1970 amendments to the Bankruptcy Act of 1898, questions concerning the nondischargeability of a particular debt were largely decided outside the bankruptcy forum.[26] Typically, a debtor who obtained a discharge would plead the discharge as a defense when sued by a creditor to enforce a discharged obligation. In turn, the creditor could overcome the debtor's defense by demonstrating that the obligation fell within one of the categories of nondischargeable debts enumerated in the bankruptcy statutes.

Significantly, many of these suits involved collection actions brought to enforce contractual obligations arising from promissory notes. Not surprisingly, debtors would frequently attempt to limit the court's inquiry into the underlying nature of the transaction giving rise to a particular note in order to avoid the revelation of any connection with fraudulent conduct, while creditors would often seek to expand this inquiry. For discharge purposes, courts developed the practice of looking beneath the form of a promissory note to determine if the circumstances surrounding the underlying transaction revealed evidence of fraud.

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26. Although only federal courts exercising bankruptcy jurisdiction could grant a discharge, prior to 1970, the determination of whether a particular debt fell outside the scope of the debtor's discharge was largely left for nonbankrutpcy courts to decide. In 1970, Congress amended section 17 to provide that the bankruptcy courts had the power to resolve the issue of nondischargeability. *See Brown v. Felsen*, 442 U.S. 127, 129-30 (1979) (explaining change); 1A Collier on Bankruptcy, ¶ 17.01 at 1580-80.2, 1745-50 (14th ed. 1979) (same).

In the seminal case of *Argall v. Jacobs*, 87 N.Y. 110 (1881), a creditor brought suit against a debtor to enforce a series of promissory notes that the debtor procured by fraud. The debtor sought to defend the action by interposing his discharge under the Act of 1867. In response, the creditor argued that the debtor's discharge did not apply owing to the existence of fraud in the underlying transaction. The debtor countered that the form of the creditor's action did not properly involve any allegation of fraud, but had been brought merely to enforce the notes, thereby preventing any inquiry into the debtor's alleged fraud for discharge purposes. The court disagreed, reasoning that, because the debtor had been guilty of fraud in issuing the notes, the debt was nondischargeable regardless of the character of the creditor's lawsuit:

> These promissory notes were debts of the defendants, and the plaintiff was induced by the fraud of the defendants to sell goods to them and take their notes therefore, and hence these debts were created by their fraud within the meaning of the Bankruptcy Act. It was not needful that the plaintiff should allege the fraud in his complaint.

Id. at 113-14.

Similarly, in *Strang v. Bradner*, 114 U.S. 555 (1885), two debtors procured notes by fraud, and the injured creditors brought suit to recover their losses. In analyzing the dischargeability issue, the Court reasoned that it made no difference whether the creditors asserted claims for fraud or for contractual indemnity on the notes. Emphasizing that "no *debt created by the fraud* of the bankrupt shall be discharged," *id.* at 560-61, the Court explained that "[i]t is . . . clear that, whether the claim asserted by plaintiffs is regarded as one arising out of deceit or fraud by the defendants, or as a debt

created by their fraud, the discharges in bankruptcy do not constitute a defense." *Id.* at 561.

Decisions under the subsequent Act of 1898 involving promissory notes likewise followed this approach. For example, in *Gregory v. Williams*, 189 P. 932 (Kan. 1920), a man procured $200 from a woman based on fraudulent representations. When she discovered the fraud, she demanded return of the funds. Unable to pay, he gave her a promissory note. When he defaulted on the note, she brought suit to enforce it. After the man filed for bankruptcy, he asserted that the note fell within the scope of his discharge as a contractual liability. The court disagreed, finding the obligation to have arisen as a result of the man's fraud, concluding for bankruptcy purposes that the "fraud was not extinguished when the note was given." *Id.* at 933. The court further reasoned:

> Taking the note by the plaintiff after she had discovered the defendant's fraud . . . did not take the indebtedness that was evidenced by the note out of the operation of section 17 of the Bankruptcy Act. The debt remained one for obtaining property by false pretenses and false representations, and the fraud was not waived, so as to discharge the defendant from his obligation to pay.

Id. at 934.

Likewise, in *Mathewson v. Naylor*, 18 Cal. App. 2d 741, 64 P.2d 979 (Cal. Ct. App. 1937), the debtor issued a promissory note to his creditor to cover certain debts incurred on the basis of false representations. After the debtor defaulted, the creditor sued on the note, and the debtor interposed his discharge as a defense, arguing that the note extinguished the fraud. Rejecting this argument, the court concluded:

> There was, therefore, evidence sufficient to have supported a finding that the defendant had obtained the money of the plaintiff by false representations. Even if the notes given thereafter may be said to have waived the fraud and substituted a contractual obligation in its place, nevertheless, inasmuch as the notes represented a liability which had in its inception in the securing of money by the making of false representations, the action on the note would not be barred by a discharge in bankruptcy.

Id. 18 Cal. App. 2d at 744, 64 P.2d at 981; *see also United States Credit Bureau v. Manning*, 147 Cal. App. 2d 558, 561, 305 P.2d 970, 972 (Cal. App. Ct. 1957) ("In an action on a promissory note to which the defendant pleads as a defense his discharge in bankruptcy, it is proper to receive evidence with respect to the nature of the liability represented by the note in order to determine whether it is of a character which is dischargeable."); *American Surety Co. v. McKiernan*, 304 Mich. 322, 325, 8 N.W.2d 82 (Mich. 1943); *Hartford Accident & Indem. Co. v. Flanagan*, 28 F. Supp. 415, 419 (S.D. Ohio 1939); *Symmes v. Rollins*, 93 Ga. App. 53, 146 S.E. 42 (Ga. Ct. App. 1928).

2. Under the Prior Law, Courts Also Looked Through Judgments to Determine the Presence of Fraud for Purposes of Determining Dischargeability.

Courts also developed the practice of looking through judgments to determine if a liability would be excepted from discharge. Numerous cases under the 1898 Act followed this approach, permitting review of evidence extrinsic to a judgment to determine if a liability established by the judgment would be nondischargeable owing to the presence of fraud. Other courts, however, refused to look beneath the

surface of the judgment, often invoking principles of *res judicata* for their refusal. In general, these courts typically concluded that, unless the judgment or record on its face established a liability for fraud, all inquiry regarding any fraudulent underpinnings was foreclosed. *See Brown v. Felsen*, 442 U.S. 127, 130-31, n.4 (1979) (noting split of authority); *see also* 1A Collier on Bankruptcy, ¶ 17.16[4] at 1643-46 (14th ed. 1979) (collecting cases).

In *Brown v. Felsen*, 442 U.S. 127 (1979), this Court resolved this split in favor of the practice of looking through a judgment for evidence of fraudulent conduct. The decision in *Brown* is especially important because the circumstances of that case are virtually indistinguishable from those of the present controversy.

In *Brown*, the creditor ("Brown") guaranteed the obligations of the debtor ("Felsen") to a third-party lender. After the lender brought suit against Brown on the guarantee, Brown asserted a claim against Felsen alleging fraud. The parties settled the suit by stipulation, and the trial court entered a consent judgment based on the settlement. Neither the stipulation nor the judgment specified Brown's theory of recovery, nor did the judgment make any mention of Felsen's fraud.

Thereafter, Felsen filed for bankruptcy and sought to have his debt discharged. Brown, in turn, sought to determine in the bankruptcy court that the obligation fell within the fraud exception of section 17 of the Bankruptcy Act. As the Court noted, pursuant to the 1970 amendments to the Act, the bankruptcy court was authorized to resolve the question of nondischargeability. *Brown*, 442 U.S. at 129-30.

During the course of the litigation, Felsen argued that principles of *res judicata* prevented the bankruptcy court from

looking through the prior state court judgment. The bankruptcy court agreed, concluding that the obligation was dischargeable. On appeal, both the district court and the court of appeals affirmed. On further review, this Court reversed.

Quoting *Local Loan Co. v. Hunt*, the Court observed: "Through discharge, the Bankruptcy Act provides 'a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'" *Id.* at 128 (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)). As the Court also observed, "[b]y seeking discharge, however, respondent [Felsen] placed the rectitude of his prior dealings squarely in issue, for, as the Court has noted, the Act limits that opportunity to the 'honest but unfortunate debtor.'" *Id.*

As the Court further explained, the nondischargeability provisions of section 17 of the Act merely prescribe the "*types* of debts [that] are not affected by a discharge," not the scope of the bankruptcy court's inquiry. *Id.* at 129. The Court concluded:

> Refusing to apply res judicata here would permit the bankruptcy court to make an accurate determination whether respondent in fact committed the deceit, fraud, and malicious conversion which petitioner alleges. These questions are now, for the first time, squarely in issue. *They are the type of question Congress intended that the bankruptcy court would resolve. That court can weigh all the evidence, and it can also take into account whether or not petitioner's failure to press these allegations at an earlier time betrays a weakness in his case on the merits.*

Id. at 138 (emphasis added); *see also Pepper v. Litton*, 308 U.S. 295, 305-06 (1939) (*res judicata* did not preclude the bankruptcy court from reexamining a judgment for purposes of the allowance and payment of a creditor's claim, and, in exercising its function, the court could "look behind the judgment").

Significantly, the Court found additional support for its conclusion in the historical evolution of section 17. Reviewing the expansion of the fraud exception over time, the Court noted that the history indicates that "Congress intended the fullest possible inquiry" into the nature of debts for discharge purposes. *Brown*, 442 U.S. at 138. The Court further explained that this history "suggests that all debts arising out of conduct specified in § 17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.*

The decision of the Court of Appeals in this case clearly conflicts with the rationale of *Brown* and the broad authority of the bankruptcy courts to inquire into the "true nature" of an obligation for purposes of determining its dischargeability. Because this rationale properly carries over under the discharge provisions of the current Bankruptcy Code, the decision of the court below is likewise at odds with the current law.

B. The Rationale of *Brown v. Felsen* Endures under the Bankruptcy Code, and the Decision of the Court Below Conflicts with the Policy, Structure, and Operation of the Bankruptcy System.

As the Court further observed in *Brown*, the discharge provisions of section 523 are materially the same as those under section 17 of the former Bankruptcy Act. *See Brown v. Felsen*, 442 U.S. at 129 n.1. In relevant part, section 523(a)(2) provides

that a debt is nondischargeable if it is "for money [or] property . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2). Like section 17 of the former Act, although this provision clearly describes a *category* of debt that is nondischargeable, it does not restrict the scope of the bankruptcy court's inquiry in determining whether a particular obligation is excepted from discharge owing to the presence of fraud. *See Cohen v. De La Cruz*, 523 U.S. 213, 220 (1998) (observing that each subsection of section 523(a) introduces "a category of nondischargeable debt"); *Grogan v. Garner*, 498 U.S. 279, 287 (1991) (observing that section 523 renders nondischargeable "certain categories of debts"). Given the similarity between the new law and the old, it is difficult to understand why the bankruptcy court's inquiry under section 523 should be any less extensive or searching than under its predecessor. On the contrary, just as restricting the inquiry of the bankruptcy courts would have violated the policy of the Bankruptcy Act, it likewise makes no sense under the current law.

1. The Relevant Discharge Policy of the Bankruptcy Code Is the Same as the Policy of the Former Law.

As this Court explained in a recent decision construing section 523(a), the general policy animating the discharge exceptions under the Code is the same as under the former section 17: "[t]he Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'" *Cohen*, 523 U.S. at 217 (quoting *Grogan v. Garner*, 498 U.S. at 287, and citing *Brown v. Felsen*, 442 U.S. at 138). As the Court further explained, the language of section 523, coupled with the Code's broad definitions of "claim" and "debt," compel the conclusion that any debt "arising from" money

or property obtained by fraud falls within the scope of the provision. *Id.* at 218; *see also id.* at 221 (finding that section 523 is best read to prohibit the discharge of "any liability arising from" the debtor's fraud); *Field v. Mans*, 516 U.S. 59, 61, 64 (1995) (describing nondischargeable debts under section 523(a) as including those "traceable to" or "resulting from" fraud); H.R. Rep. No. 95-595 at 309 (1977), *reprinted in* 1978 U.S.C.C.A.N. at 6266 (describing the Code's definition of a "claim" as the "broadest possible" so that "all legal obligations of the debtor . . . will be able to be dealt with in the bankruptcy case"). Obviously, in order to determine whether a particular debt "arises from," is "traceable to," or "results from" fraudulent conduct, the bankruptcy court must often inquire beyond the surface of the particular debt to establish its true origins and character.

As this Court has observed, "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.'" *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (quoting *Emil v. Hanley*, 318 U.S. 515, 521 (1943)). Similarly, "[w]e . . . 'will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.'" *Cohen*, 523 U.S. at 221 (quoting *Pennsylvania Dep't of Welfare v. Davenport*, 495 U.S. 552, 563 (1990)); *see also Davenport*, 495 U.S. at 565 (O'Connor, J., dissenting) ("This Court carefully has set forth a method for statutory analysis of the Bankruptcy Code. [T]he Court presumes that Congress intended to keep continuity between pre-Code judicial practice and the enactment of the Bankruptcy Code in 1978.").

As the Court recognized in *Cohen* and *Field*, the relevant provisions of section 523 descend with only minor alteration from the 1903 provisions of section 17. *See Cohen*, 523 U.S. at 221; *Field*, 516 U.S. at 64-65. Given the continuity of the

text and policy between the relevant statutory enactments, there is no reason to abandon the established practice under the Act of looking through the form of an obligation to determine if it is properly dischargeable. Because the decision of the Court of Appeals abandoned this tradition contrary to the purpose and policy of the discharge provisions of the Code, reversal is warranted.

2. The Decision of the Court Below Conflicts with the Equitable Role and Function of the Bankruptcy Courts.

The decision of the court below also conflicts with the fundamental nature of the bankruptcy courts as courts of equity. As this Court has repeatedly explained, "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934); *see also Young v. United States*, __ U.S. __, 122 S. Ct 1036, 1041 (2002) ("bankruptcy courts . . . are courts of equity and apply the principles of equity jurisprudence"); *United States v. Energy Resources Co.*, 495 U.S. 545, 549 (1990) (stating that "bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); *Bank of Marin v. England*, 385 U.S. 99, 103 (1966) ("There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisprudence."); *Pepper v. Litton*, 308 U.S. 295, 304 (1939) ("a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the [Bankruptcy] Act, it applies the principles and rules of equity jurisprudence"); H.R. Rep. No. 95-595, at 359 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6315 (under the Bankruptcy Code, "[t]he bankruptcy court will remain a court of equity"). Likewise, orders of discharge in bankruptcy are "in every essential particular decrees in

equity." *Local Loan Co. v. Hunt*, 292 U.S. at 241 (citing *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 192 (1902); *Commercial Bank of Manchester v. Buckner*, 20 How. 108, 118 (1857)).

Consistent with their status as equity tribunals, bankruptcy courts have an obligation to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in [the] administration of the bankruptcy estate." *Pepper v. Litton*, 308 U.S. at 308 (footnote omitted). As the Court has observed, this is essential to ensure "that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done." *Id.* at 305.

The power of the bankruptcy court to examine the circumstances surrounding any debt for discharge purposes, including the power to look through settlement agreements to determine if a settled obligation is traceable to fraudulent conduct, is fundamental to its role as a court of equity. "Equity always attempts to get at the substance of things, and to ascertain, uphold, and enforce rights and duties which spring from the *real* relations of parties. It will never suffer the mere appearance and external form to conceal true purposes, objects, and consequences of transactions." *Pomeroy's Equity Jurisprudence*, § 378, p. 41 & n.3 (5th ed. 1941) (quoting *Loomis v. Callahan*, 196 Wis. 518, 220 N.W. 816, 821 (1928) (dissenting opinion; majority opinion overruled by *State of Wisconsin ex rel. Thompson v. Giessel*, 267 Wis. 331, 65 N.W.2d 529, 540 (1954) ("It has always been recognized as the right, if not always as the absolute duty, of a court clothed with equitable jurisdiction which is here properly invoked, to apply its X-rays to masks and covers and see through to the real substance.")); *see generally SEC v. United States Realty & Improv. Co.*, 310 U.S. 434, 457 (1940) ("Good sense and legal tradition alike enjoin that an enactment of Congress

dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part."). In contrast, the approach taken by the court below is inconsistent with these basic concepts. In no sense is it equitable for a bankruptcy court to ignore fraud in the administration of the Bankruptcy Code's discharge provisions. *See Pepper v. Litton*, 308 U.S. at 312 ("when there is . . . a 'planned and fraudulent scheme' . . . the necessity of equitable relief against that fraud becomes insistent."). Because the decision of the Court of Appeals conflicts with the obligation of the bankruptcy court to ensure that fraud does not taint the administration of discharge in bankruptcy cases, it is fundamentally unsound.

3. The Decision of the Court Below Conflicts with the Larger Structure and Operation of the Bankruptcy Code.

Finally, the approach taken by the court below is inconsistent with the structure and operation of the Bankruptcy Code as a whole, and if recognized, would interfere with the Code's successful administration. Embedded in the court's approach is the view that settled obligations should not be disturbed in bankruptcy, not even to fulfill the Code's discharge provisions. But the very nature of bankruptcy law is to alter nonbankruptcy obligations to the extent necessary to serve the goals of the statutory regime. *See Ashton v. Cameron County Water Improv. Dist.*, 298 U.S. 513, 530 (1936) ("The especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned — to change, modify or impair the obligations of their contracts."); *see also United States v. Energy Resources Co.*, 495 U.S. at 549 ("bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); *Northern Pipeline Constr. Co. v. Marathon*

Pipe Line Co., 458 U.S. 50, 71 (1982) (Brennan, J., plurality opinion) ("the restructuring of debtor-creditor relations . . . is at the core of the federal bankruptcy power").

Exercising this authority, courts routinely pierce the form of a variety of transactions in order to administer the Code's remedial provisions. For example, in the administration of the Code's preference rules, courts have often looked through the form of a transaction to discern its substance. *See White v. Cotzhausen*, 129 U.S. 329, 340 (1889) ("a court of equity, when properly invoked, was bound to look through and beyond the form, and have regard to the substance, and, having done so, to find and declare these preferential judgments void, under the statute, and set them aside."); *In re Seaway Express Corp.*, 1991 U.S. App. Lexis 17511, *6 (9th Cir. 1991); *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, 970 (2d Cir. 1977); *Hughes v. Machen*, 164 F.2d 983, 988 (4th Cir. 1947); *Citizens' Nat'l Bank of Gastonia v. Lineberger*, 45 F.2d 522, 527-28 (4th Cir. 1930). Similarly, courts have ignored form in favor of substance in the application of the Code's rules governing the treatment of executory contracts, including resolving the proper characterization of obligations as leases or forms of secured financing. *See In re PCH Assocs.*, 949 F.2d 585, 597 (2d Cir. 1991); *International Trade Admin. v. Rensselear Polytechnic Inst.*, 936 F.2d 744, 748 (2d Cir. 1991); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1183 (9th Cir. 1988). Likewise, courts have refused to elevate form over substance in the application of the Code's setoff rules, as well as in the recharacterization of loans as equity contributions. *See Drexel v. Berney*, 122 U.S. 241, 254 (1887) ("Equity will look through the form of the transaction, and adjust the equities of the parties with a view to its substance, rather than its form"); *In re Transystems, Inc.*, 569 F.2d 1364, 1370

(5th Cir. 1978). In addition, courts have disregarded form in favor of substance in the administration of the Code's rules dealing with the treatment of claims. *See Pepper v. Litton*, 308 U.S. 295, 305-10 (1939) (reviewing equitable powers of the bankruptcy court to adjust claims); *In re Holm*, 931 F.2d 620, 623 (9th Cir. 1991); *In re Inland Gas Corp.*, 187 F.2d 813, 817 (6th Cir. 1951); *In re Thrifty Oil Co.*, 249 B.R. 537, 544 (S.D. Cal. 2000); *In re Smith*, 249 B.R. 328, 337-38 (Bankr. S.D. Ga. 2000).

Under ordinary principles of bankruptcy law, there is no basis for the conclusion that a settled obligation is or should be immune from searching examination by the bankruptcy court in order to fulfill the Code's discharge policy. Because the decision of the court below conflicts with the basic operation of the Bankruptcy Code, it is untenable.

CONCLUSION

For the foregoing reasons, the Court should reverse the judgment of the Fourth Circuit in this case.

Respectfully submitted,

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